2010-2011-2012

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAX LAWS AMENDMENT (2012 MEASURES NO. 2) BILL 2012
PAY AS YOU GO WITHHOLDING NON-COMPLIANCE TAX BILL 2012
INCOME TAX (MANAGED INVESTMENT TRUST WITHHOLDING TAX) AMENDMENT BILL 2012

EXPLANATORY MEMORANDUM

(Circulated by the authority of the
Deputy Prime Minister and Treasurer, the Hon Wayne Swan MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
CGT	capital gains tax
Commissioner	Commissioner of Taxation
Corporations Act	*Corporations Act 2001*
GIC	general interest charge
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1953	*International Tax Agreement Act 1953*
ITAA 1997	*Income Tax Assessment Act 1997*
MIT	Managed investment trust
PAYG	Pay As You Go
SGA Act 1992	*Superannuation Guarantee (Administration) Act 1992*
TAA 1953	*Taxation Administration Act 1953*
2010 amendments	*Tax Laws Amendment (2010 Measures No. 1) Act 2010*
TOFA	taxation of financial arrangements
TOFA Act	*Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009*
TOFA explanatory memorandum	explanatory memorandum to the Tax Laws Amendment (Taxation Of Financial Arrangements) Bill 2009
WIP	work in progress

General outline and financial impact

Companies' non-compliance with PAYG withholding and superannuation guarantee obligations

Schedule 1 to this Bill strengthens directors' obligations to cause their company to comply with its existing Pay As You Go (PAYG) withholding and superannuation guarantee requirements. These amendments reduce the scope for companies to engage in fraudulent phoenix activity or escape liabilities and payments of employee entitlements by:

- extending the director penalty regime to make directors personally liable for their company's unpaid superannuation guarantee amounts;
- ensuring that directors cannot discharge their director penalties by placing their company into administration or liquidation when PAYG withholding or superannuation guarantee remains unpaid and unreported three months after the due date; and
- in some instances, making directors and their associates liable to PAYG withholding non-compliance tax where the company has failed to pay amounts withheld to the Commissioner of Taxation (Commissioner).

Date of effect: Broadly, these amendments will commence on the day on which this Bill receives Royal Assent.

Proposal announced: These proposals were announced in the 2011-12 Budget, confirming an election commitment of 8 August 2010.

Financial impact: The revenue impact of this measure is as follows:

2011-12	***2012-13***	***2013-14***	***2014-15***	***2015-16***
$10m	$40m	$95m	$95m	$60m

Human rights implications: This Schedule does not raise any human rights issue. See *Statement of Compatibility with Human Rights* — Chapter 1, paragraphs 1.163 to 1.167.

Compliance cost impact: The compliance costs associated with this measure are estimated to be a small increase in compliance activities for certain directors and their associates. The costs, for the most part, are for companies who would be actively seeking to avoid their tax and superannuation obligations to gain an unfair competitive advantage.

Summary of regulation impact statement

Regulation impact on business

Impact: This Schedule deters companies from engaging in fraudulent phoenix activities and improves the regulatory environment for businesses that comply with the tax law by paying PAYG withholding to the Commissioner and superannuation guarantee for the benefit of employees. This is achieved by providing disincentives for companies and their directors that do not comply with their tax law and employee obligations.

Main points:

- These amendments are not expected to increase compliance costs or operating costs for companies or company directors who are already causing their company to comply with its existing tax or superannuation obligations.
- These amendments reduce the incentive for companies to engage in fraudulent phoenix activities or to avoid payment of liabilities in order to undercut other companies who are complying with their tax and superannuation obligations.
- Expanding the director penalty regime to superannuation guarantee improves the likelihood that employees receive the superannuation contributions they are entitled to.

Amendments to the TOFA consolidation interaction and transitional provisions

Schedule 2 to this Bill amends the taxation of financial arrangements (TOFA) consolidation interaction provisions in the *Income Tax Assessment Act 1997* and the transitional provisions in the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* (TOFA Act).

The amendments to the TOFA consolidation interaction provisions ensure that the tax treatment of financial arrangements that are part of a

joining/consolidation event is consistent with the TOFA tax timing rules and that the tax treatment of liabilities that are, or are part of, a financial arrangement takes into account changes in the value of the liability other than the repayment of the liability.

The amendments to the TOFA transitional provisions ensure that the TOFA consolidation interaction provisions apply where:

- a joining/consolidation event occurred prior to a consolidated group starting to apply the TOFA provisions in relation to its financial arrangements; and
- the head company has made an election to apply the TOFA provisions to its existing financial arrangements.

Date of effect: The TOFA consolidation interaction and TOFA transitional amendments commence from the commencement of the TOFA Act (that is, 26 March 2009). The TOFA consolidation interaction provisions apply from taxpayers' first TOFA applicable income year. The TOFA transitional amendments apply from their commencement.

Proposal announced: These amendments were announced in the then Assistant Treasurer and Minister for Financial Services and Superannuation's Media Release No. 159 of 25 November 2011.

Financial impact: These amendments are expected to protect a significant amount of revenue over the forward estimates and generate a revenue gain of $253 million over that period.

2012-13	***2013-14***	***2014-15***	***2015-16***
$66m	$46m	$61m	$80m

Human rights implications: This Schedule does not raise any human rights issues. See *Statement of Compatibility with Human Rights* — Chapter 2, paragraphs 2.94 to 2.99.

Compliance cost impact: These amendments clarify the operation of the TOFA consolidation interaction and TOFA transitional provisions. This provides more certainty for consolidated groups applying the TOFA provisions in relation to their financial arrangements.

Consolidation

Schedule 3 to this Bill amends the *Income Tax Assessment Act 1997* to modify the consolidation tax cost setting and rights to future income rules

so that the tax outcomes for consolidated groups are more consistent with the tax outcomes that arise when assets are acquired outside the consolidation regime.

Date of effect: The changes affecting a corporate acquisition will depend on the time when the acquisition took place. That is, different changes apply to, broadly, acquisitions before 12 May 2010, after 30 March 2011 and the intervening period. For corporate acquisitions that, broadly, took place before 12 May 2010, the changes prevent the retrospective operation of unintended effects of, and perceived weaknesses in, amendments to the law that were made in 2010. These changes are necessary to protect a significant amount of revenue that would otherwise be at risk.

Proposal announced: This measure was announced in the then Assistant Treasurer's Media Release No. 159 of 25 November 2011.

Financial impact: The measure has a nil revenue impact. However, it does protect a significant amount of revenue that otherwise would be at risk over the forward estimates period.

Human rights implications: This Schedule does not raise any human rights issue. See *Statement of Compatibility with Human Rights* — Chapter 3, paragraphs 3.136 to 3.139.

Compliance cost impact: Low.

Managed Investment Trust final withholding tax rate

The Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2012 amends the *Income Tax (Managed Investment Trust Withholding Tax) Act 2008* to increase the Managed Investment Trust (MIT) final withholding tax from 7.5 per cent to 15 per cent on fund payments made in relation to income years that commence on or after 1 July 2012.

Schedule 4 to Tax Laws Amendment (2012 Measures No. 2) Bill 2012 makes consequential amendments to the *Taxation Administration Act 1953* to give effect to the increase in the concessional MIT final withholding tax rate imposed by the Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2012.

Date of effect: The amendments apply from 1 July 2012.

Proposal announced: The measure was announced as part of the 2012-2013 Budget.

Financial impact: Expected to generate approximately $260 million, in revenue, over the forward estimates.

2012-13	***2013-14***	***2014-15***	***2015-16***
$50m	$65m	$70m	$75m

Human rights implications: This Schedule does not raise any human rights issue. See *Statement of Compatibility with Human Rights —* Chapter 4, paragraphs 4.10 to 4.13

Compliance cost impact: Low.

Chapter 1
Companies' non-compliance with PAYG withholding and superannuation guarantee obligations

Outline of chapter

1.1 Schedule 1 to this Bill amends the *Taxation Administration Act 1953* (TAA 1953) by:

- extending the director penalty regime to make directors personally liable for their company's unpaid superannuation guarantee amounts;
- ensuring that directors cannot discharge their director penalties by placing their company into administration or liquidation when Pay As You Go (PAYG) withholding or superannuation guarantee remains unpaid and unreported three months after the due date; and
- in some instances, making directors and their associates liable to PAYG withholding non-compliance tax (effectively reducing credit entitlements) where the company has failed to pay amounts withheld to the Commissioner of Taxation (Commissioner).

1.2 The tax on directors and their associates is imposed by the Pay As You Go Withholding Non-compliance Tax Bill 2012.

Context of amendments

Director penalty provisions

1.3 In 1993 the director penalty regime was introduced to assist the Commissioner to recover certain company liabilities. The director penalty regime replaced the Commissioner's priority that previously existed under insolvency law for certain amounts withheld (particularly from salary or wages) but not paid to the Commissioner.

1.4 In 2010 the director penalty regime was re-written into Division 269 in Schedule 1 to the TAA 1953, with minimal policy change.

1.5 The policy objective of the director penalty regime is to ensure that directors cause their company to meet certain tax obligations or promptly put the company into liquidation or voluntary administration.

1.6 Under the tax laws companies have an obligation to withhold amounts from certain payments they make, such as wages to employees and fees to directors. There is a further obligation to pay those withheld amounts to the Commissioner (and to pay estimates of those amounts where applicable). These obligations exist under the PAYG withholding regime.

1.7 The director penalty regime makes directors of companies that fail to comply with their obligation to pay amounts withheld under the PAYG withholding regime to the Commissioner (or fail to pay an estimate of their PAYG withholding liability) personally liable for the amount that the company should have paid, through the imposition of a penalty.

1.8 Where the company fails to pay such amounts, the existing director penalty regime makes directors liable to a penalty equal to the amount the company should have paid at the end of the day the company is due to meet its obligation.

1.9 The Commissioner must not commence proceedings to recover a director penalty until 21 days after he gives the director a written penalty notice.

1.10 The Commissioner uses these provisions to pursue directors of companies that fail to meet their PAYG withholding obligations, including directors of fraudulent phoenix companies who often fail to meet their PAYG withholding obligations.

1.11 Phoenix activity poses a significant threat to employee entitlements, government revenue, and the economy as a whole. In its most basic form, a fraudulent phoenix company is used to intentionally accumulate debts and then is placed into voluntary administration or liquidation to avoid paying those debts. The business then ‘re-emerges’ as another corporate entity, controlled by the same person or group, but free of debts. However, some aspects of the director penalty regime limit its efficacy in ensuring that directors cause their companies to comply with their obligations, including in phoenix cases. Most notably, as directors are provided 21 days’ notice of the penalty before the Commissioner is able to commence proceedings to recover the liability, some directors extinguish their personal liability by placing the company into voluntary

administration or liquidation within that notice period and before the Commissioner has an opportunity to commence proceedings to recover the debt. This often means that the full amount of PAYG withholding liabilities is never recovered.

1.12 Compounding these problems is the ability of directors to continue to claim PAYG withholding credits (for amounts withheld from payments to them by the company) in their individual tax returns, even when the company has failed to pay some or all of its PAYG withholding liability to the Commissioner.

1.13 A further limitation of the director penalty regime is that its application is restricted to PAYG withholding obligations.

Summary of new law

1.14 These amendments protect workers' entitlements and strengthen directors' obligations by:

- expanding the application of the director penalty regime to unpaid superannuation guarantee charge;
- ensuring that directors cannot discharge their director penalties by placing their company into administration or liquidation when PAYG withholding or superannuation guarantee remains unpaid and unreported three months after the due date; and
- in some instances, making directors and their associates liable to PAYG withholding non-compliance tax (effectively reducing credit entitlements) where the company has failed to pay amounts withheld to the Commissioner.

1.15 The tax on directors and their associates is imposed by the Pay As You Go Withholding Non-compliance Tax Bill 2012.

1.16 These amendments, and the Commissioner's ability to target their application, act to deter company directors from engaging in phoenix activities or using amounts for company or other purposes that should be paid to the Commissioner or superannuation funds.

Comparison of key features of new law and current law

New law	*Current law*
In addition to liability for PAYG withholding amounts, directors are personally liable for their company's unpaid superannuation guarantee charge.	Directors are personally liable for their company's unpaid PAYG withholding amounts, including estimates of PAYG withholding liabilities.
A new director is not liable to a director penalty for company debts until 30 days after they become a director.	New directors can be liable for outstanding debts if they fail to arrange for the company to take necessary action within 14 days of becoming a director.
In addition to estimating unpaid PAYG withholding liabilities, the Commissioner can estimate unpaid superannuation guarantee charge.	An estimate can only be made in relation to a company's PAYG withholding liabilities.
In addition to the requirement that the Commissioner serve notice on a director, the Commissioner may also serve a copy of a director penalty notice on the director at his or her tax agent's address.	The Commissioner may seek to recover a director penalty by issuing a director penalty notice and may commence proceedings to recover 21 days after the notice was issued.
The current law continues to apply. However, where three months has lapsed after the due day for the company liability and the liability remains unpaid and unreported the director penalty is not remitted as a result of placing the company into administration or beginning to wind it up. New directors are not subject to these restricted remission options until three months after they become a director of a company, rather than three months after a debt arose.	A director can extinguish their personal liability by causing one of three things to happen before the notice is issued or within that 21 day notice period: • payment of the debt; • appointment of an administrator under section 436A, 436B or 436C of the *Corporations Act 2001*; or • beginning the winding up of the company.

New law	*Current law*
In addition to these defences, a director that becomes liable to a director penalty for not causing its company to comply with its superannuation obligations is not liable to a director penalty if the company treated the *Superannuation Guarantee (Administration) Act 1992* (SGA Act 1992) as applying to a matter in a way that was reasonably arguable and the company took reasonable care in applying the SGA Act 1992 to the matter.	A director has a defence in relation to a director penalty if the director had an illness that prevented him or her participating in the management of the company, or if the director took all reasonable steps to ensure compliance.
Company directors and their associates who are entitled to a credit attributable to a payment made by a company that has failed to pay amounts withheld under PAYG withholding to the Commissioner, can be liable to pay PAYG withholding non-compliance tax.	Company directors and their associates are entitled to PAYG withholding credits withheld by the company from a withholding payment made to them, such as salary, regardless of whether the company has paid the PAYG withholding amounts to the Commissioner.

Detailed explanation of new law

Extending the director penalty regime to unpaid superannuation guarantee amounts

Collecting superannuation guarantee charge for the benefit of employees

1.17 Extending the director penalty regime to superannuation guarantee charge better secures workers' entitlements. The amount of the director penalty represents amounts of unpaid superannuation guarantee charge that should have been applied for the benefit of the employee, by providing it to a superannuation fund.

1.18 Amounts collected under the director penalty regime that represent superannuation guarantee charge are dealt with in the same way as superannuation guarantee charge amounts collected under the SGA Act 1992. ***[Schedule 1, items 35 and 48, subsections 63A(3) and (4) of the SGA Act 1992]***

Imposing and quantifying director penalties

1.19 Directors of companies that are registered under the *Corporations Act 2001* are personally liable for their company's failure to meet its superannuation guarantee obligations. This liability is imposed by a director penalty through an extension of the existing director penalty regime. ***[Schedule 1, items 49 to 51, paragraph 269-5(a), subsection 269-10(1) and section 269-1 in Schedule 1 to the TAA 1953]***

1.20 Where an employer fails to pay the appropriate amount of superannuation guarantee contributions on behalf of their employees the outstanding amount is referred to as a superannuation guarantee shortfall. Where an employer has a superannuation guarantee shortfall, a superannuation guarantee charge arises.

1.21 The director penalty represents the amount of the company's superannuation guarantee charge either:

- as assessed by the employer through the lodgment of a superannuation guarantee statement;
- as assessed by the Commissioner through a default assessment; or
- as estimated by the Commissioner and notified in a notice of an estimate issued by the Commissioner.

[Schedule 1, items 41, 42 and 51, subsections 268-10(1) and (3) and items 4 and 5 in the table in subsection 269-10(1) in Schedule 1 to the TAA 1953]

Timing — when company directors become personally liable

1.22 Under subsections 269-20(1) and (2) in Schedule 1 to the TAA 1953 of the existing director penalty regime, company directors are liable to a director penalty at the end of the day that the company is obliged to pay to the Commissioner its PAYG withholding amounts if the company has not met that obligation. The penalty is due and payable at the end of the day the company is obliged to pay the Commissioner.

1.23 Where a director becomes a director after the company failed to meet its obligation to pay its liability by the due day, a different set of liability rules apply.

1.24 However, under the new rules new directors will be liable to a director penalty only where they become a director after the company has failed to meet its obligation by the due day and 30 days after becoming a director, the obligation has not been met. The reason for the increase in the grace period from 14 days to 30 days is an acknowledgement of the

fact that because the director penalty regime will now apply to both PAYG withholding and the superannuation guarantee, new directors need more time to ensure their corporate affairs are in order before being liable to a personal penalty. ***[Schedule 1, items 5 and 6, paragraph 269-20(3)(b) and subsection 269-20(4) in Schedule 1 to the TAA 1953]***

1.25 Unlike PAYG withholding, the superannuation guarantee charge is not due and payable until the earlier of the employer self-assessing by lodging a superannuation guarantee statement or the Commissioner issuing an assessment.

1.26 This gives rise to the possibility that directors would escape or delay liability for director penalties by failing to lodge their superannuation guarantee statement as required, causing the superannuation guarantee charge to not become due and payable.

1.27 To avoid this outcome, and make a director personally liable for unpaid superannuation in a timely manner, the superannuation guarantee charge must be treated as payable even if it has not yet been assessed.

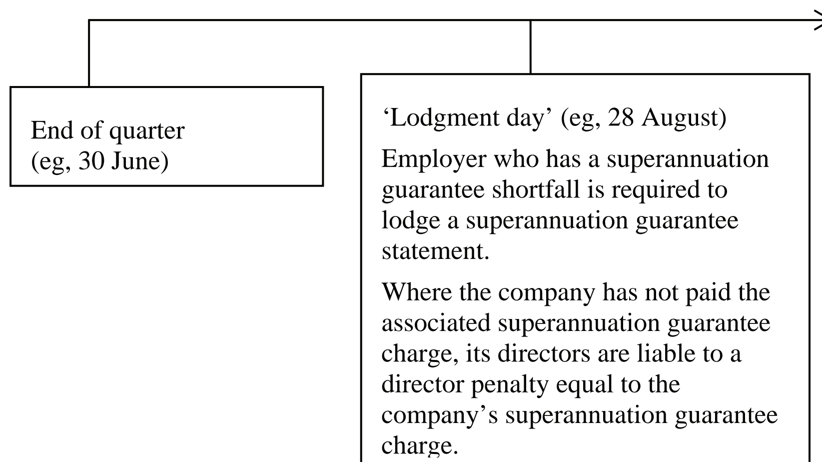
1.28 For the purpose of the director penalty regime, a company's superannuation guarantee charge is treated as payable on the day the employer is required to lodge their superannuation guarantee statement for the quarter to the Commissioner. This is either lodgment day, or a later day as allowed by the Commissioner (section 33 of the SGA Act 1992). ***[Schedule 1, item 52, subsection 269-10(3) in Schedule 1 to the TAA 1953]***

1.29 Accordingly, the existing directors are liable to a director penalty at the end of the lodgment day (or later day as allowed by the Commissioner under section 33 of the SGA Act 1992) if the company has not lodged its superannuation guarantee statement and paid the corresponding superannuation guarantee charge by the end of that day. ***[Schedule 1, items 51 and 52, subsections 269-10(1) and (3) in Schedule 1 to the TAA 1953]***

1.30 The lodgment day is a suitable day to treat the superannuation guarantee charge as falling due for the purpose of the director penalty regime as it is the day that the employer is required to lodge their superannuation guarantee statement (and where that happens, the day that the superannuation guarantee charge becomes due).

1.31 Diagram 1.1 demonstrates the timing of the liability arising, based on a quarter ending on 30 June.

Diagram 1.1: Due day of superannuation guarantee charge for the purpose of the director penalty regime



Example 1.1: Imposition of a director penalty for non-payment of superannuation guarantee amounts

> Kevin and Ash are directors of Kash Pty Ltd. Aaron is employed by Kash Pty Ltd from 1 January 2013. During the January to March quarter of the 2012-13 income year, Kash Pty Ltd failed to pay any superannuation guarantee amounts to Aaron's superannuation fund.
>
> As there is a superannuation guarantee shortfall, Kash Pty Ltd is required to report that shortfall in a superannuation guarantee statement to the Commissioner by 28 May 2013. However, Kash Pty Ltd does not report its shortfall by this date.
>
> Therefore on 28 May 2013, Kevin and Ash are liable for director penalties for the value of the superannuation guarantee charge.

Expanding the estimates regime to cover unpaid superannuation guarantee

1.32 In addition to the Commissioner's power to issue an assessment to quantify an unreported superannuation guarantee shortfall, the estimates regime can be used to estimate the unpaid and overdue amount of a superannuation guarantee charge liability. The issue of an estimate notice creates a separate liability from the underlying superannuation guarantee charge liability. A director penalty will arise from the non-payment of an estimate of superannuation guarantee charge (or PAYG withholding liability). ***[Schedule 1, items 36 to 42 and 51, sections 268-1***

and 268-5, subsections 268-10(1), (1A) and (3), and item 4 in the table in subsection 269-10(1) in Schedule 1 to the TAA 1953]

1.33 The ability to estimate a superannuation guarantee charge reduces the scope of phoenix operators and other non-compliant corporate entities to escape liabilities once they become aware that the Commissioner is pursuing them. For example, the issue of an estimate enables the Commissioner to take prompt action when an opportunity arises to secure recovery, without having to delay recovery by waiting for an assessment to be issued.

1.34 Like the director penalty regime, the estimates regime treats the superannuation guarantee charge as being payable even if it has not been assessed, to avoid problems with delaying or avoiding quantification. To enable the Commissioner to estimate the superannuation guarantee charge where it has not been assessed (and therefore is not due and payable under the SGA Act 1992), the estimates regime treats the superannuation guarantee charge as being payable on the day the superannuation guarantee shortfall for the quarter should have been reported to the Commissioner in a superannuation guarantee statement. This is the lodgment day or a later day if permitted by the Commissioner (section 33 of the SGA Act 1992). ***[Schedule 1, item 41, subsections 268-10(1) and (1A) in Schedule 1 to the TAA 1953]***

1.35 This timing is consistent with the application of the director penalty regime to unpaid superannuation guarantee charges.

Example 1.2: Director penalties for estimates of superannuation guarantee charge

> Following on from Example 1.1, after 28 May Aaron and another employee, Graeme, make a complaint to the Commissioner about their unpaid superannuation.
>
> Kash Pty Ltd has not lodged a superannuation guarantee statement and therefore has not reported the shortfall by lodgment day and the Commissioner has not permitted Kash Pty Ltd to lodge its superannuation guarantee statement at a later date.
>
> Kevin and Ash are each liable to a director penalty relating to the superannuation guarantee charge from 28 May 2013, however the amount of the penalty is unknown.
>
> The Commissioner, based on the information available, issues Kash Pty Ltd a notice of an estimate of the superannuation guarantee charge under Division 268 in Schedule 1 to the TAA 1953.
>
> Kash Pty Ltd fails to pay the estimate by the end of the day it was issued, making Kevin and Ash each liable for a director penalty as a

result of the estimate. (This is consistent with the operation of the existing director penalty regime.)

The director penalty liability is due and payable at the end of the day the estimate is issued to the company.

1.36 Unlike estimates of PAYG withholding liabilities, the general interest charge (GIC) does not accrue on estimates of superannuation guarantee charge. The GIC does accrue on any assessment of the superannuation guarantee charge that is made after the estimate. ***[Schedule 1, item 43, subsection 268-75(1) in Schedule 1 to the TAA 1953]***

1.37 There may be cases where the Commissioner proceeds with a director penalty based on an estimate of a superannuation guarantee charge and is unable to identify immediately the relevant employee or employees who are entitled to the superannuation that is represented by amounts collected under the director penalty regime. In these cases, the collected amounts are held in consolidated revenue until the employee or employees are identified. During that time an employee may identify their claim to a superannuation entitlement. ***[Schedule 1, item 35, subsections 63A(3) and (4) of the SGA Act 1992]***

1.38 Once the employee or employees and their entitlements are identified, the money is applied for the benefit of the employee via an assessment in the same way as a collection of superannuation guarantee charge under the SGA Act 1992.

Director's ability to provide facts in relation to an estimate

1.39 Consistent with estimates of PAYG withholding liabilities, a director may submit a statutory declaration or affidavit, which must verify:

- the director's name and address;
- for each employee for which there is unpaid superannuation guarantee shortfall — their name and postal address, and if known, their tax file number;
- the amount of the superannuation guarantee shortfall; and
- what has been done to comply with your obligation to pay the relevant superannuation guarantee charge to the Commissioner.

The amount or amounts of individual superannuation guarantee shortfall mentioned in the statutory declaration or affidavit is a factor in determining the amount of the superannuation guarantee charge

mentioned in paragraph 268-10(1)(b) in Schedule 1 to the TAA 1953. ***[Schedule 1, item 45, subsection 268-90(2A) in Schedule 1 to the TAA 1953]***

1.40 The submission of a statutory declaration or affidavit may result in the estimate being reduced or revoked.

Recovering director penalties

1.41 In order to recover a director penalty from a director, the Commissioner must issue a director penalty notice and wait until the end of 21 days after issuing that notice before commencing proceedings. ***[Schedule 1, items 4 and 53, subsection 269-25(1) in Schedule 1 to the TAA 1953]***

1.42 The Commissioner may also send a copy of a director penalty notice to a director's registered tax agent; this provides the Commissioner with an additional means of bringing the penalty to the director's attention. The tax agent has the professional knowledge to advise the director of the importance of the notice and the actions directors can take. However, whether the Commissioner chooses to avail himself of this right does not affect whether the Commissioner has given a director the actual notice, or how the Commissioner may give a director the actual notice. ***[Schedule 1, item 3, subsection 269-52 in Schedule 1 to the TAA 1953]***

1.43 A director penalty is remitted if, before receiving a director penalty notice, or within 21 days of receiving a director penalty notice, any of the following things happen:

- the company complies with its obligation;
- an administrator of the company is appointed; or
- the company begins to be wound up.

[Schedule 1, item 8, subsection 269-30(1) in Schedule 1 to the TAA 1953]

1.44 However, where 3 months has lapsed after the due day, and the underlying liability remains unpaid and unreported, the director penalty is not remitted as a result of placing the company into administration or beginning to wind it up. ***[Schedule 3, items 8, 54 and 55, subsection 269-30(2) in Schedule 1 to the TAA 1953]***

Example 1.3: Actions that do not extinguish a director penalty

Kerry and Claire are directors of Tardy Co, which is required to pay amounts withheld under the PAYG withholding provisions to the Commissioner on a quarterly basis. During the January to March quarter in the 2013-14 income year, Tardy Co withholds $4,000 from payments made to its employees and directors.

Tardy Co fails to pay or report any of the withheld amounts to the Commissioner by the due day (21 April 2014). From that day Kerry and Claire are liable to a director penalty for the amount of the company's unpaid PAYG withholding liabilities.

By 21 July 2014, Kerry and Claire have not remitted their director penalties. The only way that they can now discharge their penalties is by causing the company to pay the amounts withheld or personally paying those amounts.

New directors

1.45 The paragraphs above explain how the recovery process applies to directors who are directors on the day that the company fails to meet the particular obligation listed in section 269-10 in Schedule 1 to the TAA 1953.

1.46 New directors are liable for director penalties under the director penalty regime if an obligation giving rise to a director penalty exists, and thirty days after the director started, the director is still under that obligation. ***[Schedule 1, items 5 and 6, paragraph 269-20(3)(b) and subsection 269-20(4) in Schedule 1 to the TAA 1953]***

1.47 In addition, a new director will not be subject to the restricted remission options until three months after he or she became a director of the company regardless of how long the company has been liable for the debt. ***[Schedule 1, item 8, subsection 269-30(3) in Schedule 1 to the TAA 1953]***

Defences available to directors who are liable to director penalties for unpaid PAYG withholding liability or superannuation guarantee charge

1.48 Where the Commissioner seeks to collect a director penalty, the existing statutory defences are available to a director. ***[Schedule 1, item 2, subsections 269-35(1) to (4A) in Schedule 1 to the TAA 1953]***

1.49 Therefore, a director is not liable for a director penalty where they can establish that:

- because of illness or for some other good reason the director was not involved in the management of the company and it was reasonable for that director not to be involved; or
- the director took all reasonable steps to ensure the directors caused one of these three things to happen (or no such steps were available):
  - the company to meet its obligation to pay;

– an administrator of the company to be appointed; or

– the company to begin to be wound up.

[Schedule 1, item 2, subsections 269-35(1) and (2) in Schedule 1 to the TAA 1953]

1.50 A director will not be considered to have taken reasonable steps simply because they assert that no reasonable steps were available to cause one of those three things to happen. ***[Schedule 1, item 2, subsection 269-35(2) in Schedule 1 to the TAA 1953]***

1.51 Criteria replicating the existing criteria in subsection 269-35(4) in Schedule 1 to the TAA 1953 are provided to assist the Commissioner in determining what are 'reasonable steps'. ***[Schedule 1, item 2, subsection 269-35(3) in Schedule 1 to the TAA 1953]***

1.52 The terms 'good reason' and 'reasonable steps' are included in the existing director penalty regime legislation and take their ordinary meaning. ***[Schedule 1, item 2, subsections 269-35(2) and (3) in Schedule 1 to the TAA 1953]***

1.53 In addition, a director is not liable to a director penalty relating to the superannuation guarantee charge, where they can establish that the penalty resulted from the company treating the SGA Act 1992 as applying to a matter or identical matters in a particular way that was reasonably arguable, and the company took reasonable care in connection with applying the SGA Act 1992 to the matter or matters. ***[Schedule 1, item 56, subsection 269-35(3A) in Schedule 1 to the TAA 1953]***

1.54 There is no corresponding defence in relation to PAYG withholding obligations because they also arise if amounts are withheld but not remitted, meaning that it is more likely a company will be conscious of its unremitted PAYG withholding obligations than it will be of its superannuation guarantee obligations.

Reasonable care

1.55 Exercising reasonable care means making a reasonable attempt to comply with the relevant law. The effort required is one commensurate with all the company's circumstances, including its knowledge, experience and skill.

Example 1.4

Fantastic Fashions Pty Ltd is a medium-sized textiles company that has 43 people working for it to produce garments. Fantastic Fashions has one person employed on a fulltime basis, and another on a part-time basis, to work on human resources (HR) issues. Among other things,

> the small HR team is responsible for determining if workers are employees or contractors for superannuation purposes. In performing this task, the HR team relies heavily on Australian Taxation Office (ATO) published material, including reviewing the ATO website for information on who is eligible for superannuation and, in particular, following a checklist provided online by the ATO to help determine the workers' status for superannuation purposes. This analysis would constitute the exercise of reasonable care.

Reasonably arguable

1.56 The term ***reasonably arguable*** is defined in subsection 995-1(1) of the *Income Tax Assessment Act 1997*(ITAA 1997) to have the meaning given by section 284-15 of Schedule 1 to the TAA 1953. A matter is reasonably arguable 'if it would be concluded in the circumstances, having regard to relevant authorities, that what is argued for is about as likely to be correct as incorrect, or is more likely to be correct than incorrect'. This definition provides a suitable standard for the purposes of the defence.

1.57 Generally, if a company has a 'reasonably arguable' position, it will have also exercised reasonable care. However, there may be unusual cases where a company has failed to exercise reasonable care, but by chance has a reasonably arguable position. Both standards must be satisfied in order for the defence to apply.

Availability of defences for collection from third parties

1.58 If the Commissioner collects amounts from third parties in order to discharge a director penalty, the director can still avail themselves of the above defences. To do so, the director must provide information to the Commissioner within 60 days of receiving notice that the recovery has occurred or receiving a copy of a notice issued to a third party under section 260-5 in Schedule 1 to the TAA 1953. That information must satisfy the Commissioner of the matters relevant to make out one of the defences. ***[Schedule 1, item 2, subsections 269-35 (4A) in Schedule 1 to the TAA 1953]***

1.59 The 60-day period to raise a defence applies to the recovery of all director penalties by methods other than court proceedings, regardless of the character of the underlying liability.

1.60 Where the Commissioner has recovered any of the penalty by applying a credit against the director penalty, the 60 days runs from when the Commissioner notifies the director that recovery action has been taken. This notification could be provided in many different forms. For example:

- a note accompanying a notice of assessment;
- a running balance account statement which shows the offset has occurred; or
- a letter explaining that offsetting has occurred.

[Schedule 1, item 2, subparagraph 269-35(4A)(a)(ii) in Schedule 1 to the TAA 1953]

Example 1.5: Applying credits against a director penalty

Hunter Co has failed to meet their obligation to pay amounts withheld under the PAYG withholding provisions to the Commissioner by the due date. A director penalty is raised against Kayleen as director of Hunter Co. To recover the penalty, the Commissioner applies credits that Kayleen is entitled to offset against her director penalty.

The Commissioner issues Kayleen with a notice of assessment. A note accompanying that notice explains that the credits have been applied against the director penalty.

Thirty days after the Commissioner issued Kayleen with her notice of assessment she provides the Commissioner with information she is relying on to satisfy the Commissioner that she was ill and unable to take part in the management of the company.

The Commissioner considers the information and is satisfied of the matters set out in the defence in subsection 269-35(1), meaning Kayleen is not liable to the director penalty. The Commissioner takes the necessary steps to return Kayleen to the position she would have been in if the credits had not been used to offset the director penalty liability.

1.61 Where the Commissioner has served a notice under section 260-5 in Schedule 1 to the TAA 1953 (the Commissioner may collect amounts from a third party) for the purpose of recovering the director penalty, the 60 days commences from when a copy of the notice is served on the director (as required by subsection 260-5(6) in Schedule 1 to the TAA 1953). ***[Schedule 1, item 2, subparagraph 269-35(4A)(a)(i) in Schedule 1 to the TAA 1953]***

Example 1.6: Period allowed to raise a defence to the recovery of a director penalty

Michael is a director of McGovern Co. McGovern Co has failed to pay its employees their superannuation guarantee entitlements and has been assessed with an SGC liability. As a result Michael has a director penalty equal to the SGC.

To recover the penalty, the Commissioner serves a notice under subsection 260-5(2) on the bank to recover money from Michael's bank account.

After serving the notice on the bank, a copy of the notice is served on Michael. The Commissioner is successful in recovering money from Michael's bank account.

Michael has 60 days from being served the copy of the notice under subsection 260-5(6) to raise a defence against the recovery of the penalty.

Where the Commissioner is satisfied that the defence is made out, the money recovered from the bank is returned to Michael.

1.62 Under the existing law, the Commissioner has considered the defences for all forms of recovery under the director penalty regime in section 269-35 in Schedule 1 to the TAA 1953. However, the setting of a distinct period is necessary to deal with the unique nature of the collection of penalties that reflect superannuation guarantee charge. Because superannuation guarantee charge is distributed to superannuation funds for the benefit of employees, and is ultimately paid out to that employee, there was a risk that if a director left it too long to raise a defence the money would be difficult to recover and repay to the director. This 60-day time frame provides certainty for directors, employees, and the Commissioner in dealing with recovery of superannuation guarantee charge.

1.63 The 60-day period is consistent with the standard objection period that applies under the taxation laws.

PAYG withholding non-compliance tax

Background

1.64 Companies (and other entities) are required to withhold a portion of certain payments, such as the wages of their employees and payment of fees to directors, and pay the amounts withheld to the Commissioner (effectively as an instalment of tax). When the Commissioner assesses the payee for that income year, the payee is then entitled to a credit equal to the total of amounts withheld during the income year. The payment summary issued by the company to the payee shows, among other things, the amount the company withheld.

1.65 It is common for fraudulent phoenix operators to withhold amounts from payments but never pay the withheld amounts to the Commissioner. This may also occur when a company is facing financial

difficulties. Instead of paying the withheld amount to the Commissioner, those amounts are used to improve their business' cash flow or for wealth creation while compliant businesses forward that money to the Commissioner as required under the law.

1.66 For the purpose of the discussion below, the term *PAYG withholding liability* refers to the amount that the company withholds but fails to pay to the Commissioner.

Overview

1.67 Company directors and their associates are liable to pay tax where their company has a PAYG withholding liability for an income year and the individual is entitled to a credit for amounts withheld by that company during the income year. ***[Schedule 1, item 14, sections 18-125 and 18-135 in Schedule 1 to the TAA 1953]***

1.68 The PAYG withholding non-compliance tax is imposed by the Pay As You Go Withholding Non-compliance Tax Bill 2012. ***[Schedule 1, item 11, subsection 995-1(1) of the ITAA 1997 and Clauses 1 to 4 of the Pay As You Go Withholding Non-compliance Tax Bill 2012]***

1.69 The imposition of tax on directors and their associates where the company has failed to meet its PAYG withholding obligations provides a new strong incentive for company directors to ensure that their companies comply with existing obligations to pay withheld amounts to the Commissioner.

1.70 The circumstances that must exist before the liability to the PAYG withholding non-compliance tax arises are different for directors and associates. ***[Schedule 1, item 14, sections 18-125 and 18-135 in Schedule 1 to the TAA 1953]***

1.71 Although the tax is due and payable, the tax is not recoverable unless the Commissioner issues a notice to the individual director or associate. The Commissioner should only issue a notice after determining that it is fair and reasonable for the individual to pay the tax. The Commissioner cannot issue a notice where the relevant director has a director penalty liability because of the company's failure to pay PAYG withholding for the income year. ***[Schedule 1, item 14, section 18-140 in Schedule 1 to the TAA 1953]***

1.72 The exposure draft of the legislation achieved this policy outcome by way of reduction in the credits of the individual director or their associate. This Bill, together with the Pay As You Go Withholding Non-compliance Tax Bill 2012, achieves the same policy outcome by way of a tax to safeguard the measure against constitutional challenge. The objective of this tax is to reverse the economic benefit of all or part of the

credit to the extent to which the director (or associate) is entitled. Consequently, the measure achieves similar outcomes to the exposure draft, although the mechanics of achieving those outcomes have changed. ***[Schedule 1, items 13 and 14, sections 18-5 and 18-120 in Schedule 1 to the TAA 1953]***

Directors of companies that do not pay withheld amounts to the Commissioner

1.73 A company director can be liable to pay the PAYG withholding non-compliance tax where the company of which they are a director has withheld more amounts from withholding payments than it has paid to the Commissioner for the director's income year. This includes where the company has paid some, but not all, of the amounts withheld to the Commissioner. ***[Schedule 1, item 14, paragraphs 18-125(1)(a) to (c) in Schedule 1 to the TAA 1953]***

1.74 The directors can be liable to pay the tax where any amount of the company's PAYG withholding for the director's income year is still outstanding after its due date. ***[Schedule 1, item 14, paragraph 18-125(1)(c) in Schedule 1 to the TAA 1953]***

1.75 To be liable, the director must also have an entitlement to a PAYG withholding credit that is attributable to an extent to an amount withheld by the company from payments made by the company to the director (such as directors fees). ***[Schedule 1, item 14, paragraph 18-125(1)(d) in Schedule 1 to the TAA 1953]***

1.76 Liability to pay the PAYG withholding non-compliance tax arises for individuals that either:

- were a director when the company was due to pay the withheld amounts to the Commissioner but failed to do so (in full); or
- became a director after the payment of withheld amounts to the Commissioner was due (and not paid) and 30 days after they started as a director, they are still a director and the overdue withholding amount is still unpaid.

[Schedule 1, item 14, subsection 18-125(2) in Schedule 1 to the TAA 1953]

Example 1.7: The director is liable to pay PAYG withholding non-compliance tax

Service Co failed to pay to the Commissioner $5,000 for amounts withheld from withholding payments (including employee wages and payments to directors) during the 2012-13 income year.

For the whole of the 2012-13 income year, including at all times when the withheld amounts were due to be paid to the Commissioner, Roxy was a director of Service Co.

During the income year Service Co withheld $3,000 from wages paid to Roxy.

After the Commissioner issued Roxy with a director penalty notice (because the PAYG withholding liability had been reported before three months elapsed), Roxy caused Service Co to appoint an administrator within 21 days and thus the director penalty was remitted.

Roxy is liable to pay the PAYG withholding non-compliance tax.

Amount of tax payable

1.77 The amount of tax payable by the director is the lesser of:

- the total amounts withheld from payments made to the individual by the company in the individual's income year (that is, the extent that the credit is attributable to amounts withheld from payments made by the company of which the individual was a director); and
- the company's PAYG withholding liability for payments made during the income year.

[Schedule 1, item 14, subsection 18-125(3) in Schedule 1 to the TAA 1953]

Example 1.8: The amount of PAYG withholding non-compliance tax where the individual's credit is less than the company debt

Computer Co has an unpaid PAYG withholding liability for the 2014-15 income year totalling $100,000.

Diego was a director of Computer Co throughout that income year and received director's fees for the income year. He is entitled to a credit of $25,000 for amounts withheld from his director's fees.

Assume Diego is not liable to a director penalty. Diego must pay $25,000 PAYG withholding non-compliance tax as the total of amounts withheld from payments to Diego is less than the value of the company's unpaid PAYG withholding liability.

Example 1.9: The amount of PAYG withholding non-compliance tax where the company debt is less than the individual's credit

Maverick Co failed to pay to the Commissioner $4,000 of amounts withheld from withholding payments made during the 2013-14 income year.

Ciara is a director of Maverick Co and is entitled to a credit of $30,000 for amounts withheld by Maverick Co from her director's fees.

Assume Ciara is not liable to a director penalty. Ciara is liable to pay $4,000 PAYG withholding non-compliance tax as the company's PAYG withholding liability is less than the total amounts withheld from payments to Ciara.

When tax is payable

1.78 The PAYG withholding non-compliance tax is due and payable on the same date as the original income tax must be paid by the individuals for that financial year. As income tax is not due to be paid unless an assessment is made, and to account for cases where no income tax is payable by the individual, the individual is treated as being required to pay income tax for the income year. ***[Schedule 1, items 14 and 15, subsection 250-10(2) and section 18-145 in Schedule 1 to the TAA 1953]***

1.79 An individual that fails to pay some or all of an amount of PAYG withholding non-compliance tax on time must pay the GIC. The GIC accrues from the day by which the unpaid amount of tax was due to be paid and stops accruing on the later of the unpaid PAYG withholding non-compliance tax being paid or the GIC on the unpaid PAYG withholding non-compliance tax being paid. ***[Schedule 1, items 12 and 14, subsection 8AAB(4) of the TAA 1953 and section 18-150 in Schedule 1 to the TAA 1953]***

Reducing the amount of the director's PAYG withholding non-compliance tax

1.80 The director may attempt to satisfy the Commissioner that they had grounds for allowing the company not to meet its PAYG withholding obligations. Where the Commissioner is satisfied that the director met one of the specified grounds, the Commissioner is required to issue a notice to reduce the amount of tax payable by that director. ***[Schedule 1, item 14, section 18-130 in Schedule 1 to the TAA 1953]***

1.81 The director may attempt to satisfy the Commissioner of these grounds before or after the liability to pay the tax arises. Regardless of when the notice to reduce the amount of tax payable is issued, the reduction has effect as if the amount of tax payable was always the amount as reduced by the notice. ***[Schedule 1, item 14, subsections 18-130(2) and (6) in Schedule 1 to the TAA 1953]***

1.82 Where the Commissioner becomes aware of circumstances that may satisfy one of the grounds for reducing the tax, for example through an application by the director or because the director successfully raised a defence to a director penalty, the Commissioner must consider the circumstances. ***[Schedule 1, item 14, subsection 18-130(2) in Schedule 1 to the TAA 1953]***

1.83 Where the Commissioner is satisfied of the grounds after the liability to pay the tax arises, the notice to reduce the amount of tax payable may only be issued within four years after the original notice of assessment. This time limit is designed to provide finality in the taxpayer's affairs. ***[Schedule 1, item 14, section 18-130 and paragraph 18-185(c) in Schedule 1 to the TAA 1953]***

Grounds on which a director may rely

1.84 The first and second grounds on which the director may rely mirror the existing defences in the director penalty regime (section 269-35 in Schedule 1 to the TAA 1953). The content and considerations are the same under both regimes.

1.85 The first ground is that a director may not be responsible for the company's non-compliance because they were not involved in the management of the company and it was reasonable for the director not to be involved because of illness or some other good reason. This applies where the director had a reasonable basis not to be involved in the management of the company at any time during the period on or before a day that the company was required to pay any of its total PAYG withholding liability and ending when the Commissioner issues a reduction notice. ***[Schedule 1, item 14, subsection 18-130(2)(a) in Schedule 1 to the TAA 1953]***

1.86 The second ground on which a director may rely to reduce their personal responsibility for the company's non-compliance is that the director took all reasonable steps to ensure that the directors caused:

- the company to pay the withholding liability;
- an administrator of the company to be appointed; or
- the company to begin to be wound up.

[Schedule 1, item 14, paragraph 18-130(2)(b) in Schedule 1 to the TAA 1953]

1.87 Alternatively, the director may satisfy the Commissioner that there were no reasonable steps that could have been taken to ensure any of those things happened. ***[Schedule 1, item 14, paragraph 18-130(2)(b) in Schedule 1 to the TAA 1953]***

1.88 The director must take all reasonable steps to cause one of those three things to happen. A reduction in the amount of tax payable is not available where no reasonable steps were available to cause only one of those three things to happen. For example, it is not sufficient for a director to say that there were no reasonable steps available to cause the company to pay because the company had insufficient funds.

1.89 To be successful in satisfying the Commissioner that there are grounds to reduce the tax payable, there must be no reasonable steps available to ensure the directors caused the company to do any of those three things. Therefore, if there were insufficient funds to pay the PAYG withholding, the directors should have taken all reasonable steps to have an administrator appointed or begin winding up the company.

1.90 In determining what would be reasonable steps for the director to have taken, the Commissioner must have regard to all of the relevant circumstances, including when, and for how long, the director was a director and took part in the management of the company. ***[Schedule 1, item 14, subsection 18-130(3) in Schedule 1 to the TAA 1953]***

Amount of the reduction in tax payable

1.91 The amount of the reduction in tax payable is determined by the Commissioner and is the amount stated in the notice issued by the Commissioner. ***[Schedule 1, item 14, subsection 18-130(4) in Schedule 1 to the TAA 1953]***

1.92 Where the director has satisfied the first ground, the Commissioner must have regard to:

- when, and for how long, the director did not take part in the management of the company;
- when, and for how long, the director could not have been expected to take part in the company; and
- what is fair and reasonable in the circumstances.

[Schedule 1, item 14, paragraphs 18-130(5)(a) and (c) in Schedule 1 to the TAA 1953]

1.93 In determining the amount of a reduction based on the second ground, the Commissioner must have regard to:

- when the individual was a director of the company;
- how long the individual was a director of the company;

- how long the director took part in the management of the company; and
- what is fair and reasonable in the circumstances.

[Schedule 1, item 14, paragraphs 18-130(5)(b) and (c) in Schedule 1 to the TAA 1953]

1.94 Where the Commissioner reduces the tax because the director has satisfied one of the grounds, and an amount has already been paid, the director will be entitled to interest. ***[Schedule 1, items 16 and 20 to 22, paragraph 3(1)(cab), subsection 10(2) and sections 3C and 10 of the Taxation (Interest on Overpayments and Early Payments) Act 1983]***

Associates of directors of companies that do not pay withheld amounts to the Commissioner

1.95 An individual who is an associate of a company director can be liable to pay PAYG withholding non-compliance tax for an income year if amounts withheld by the company have not been paid to the Commissioner by the last day for remitting any of the amounts withheld during the associate's income year. ***[Schedule 1, item 14, paragraphs 135(1)(a) to (c) in Schedule 1 to the TAA 1953]***

1.96 An ***associate*** is defined in section 995-1 of the *Income Tax Assessment Act 1997* as having the meaning given by section 318 of the *Income Tax Assessment Act 1936*. The latter section provides a very broad definition of 'associates of a natural person' which includes relatives, partners, a spouse and children of the natural person. ***[Schedule 1, item 14, paragraph 18-135(1)(a) in Schedule 1 to the TAA 1953]***

1.97 To be liable to pay the PAYG withholding non-compliance tax, the associate must be entitled to a credit which can be attributed to some extent to amounts withheld from payments such as salary or wages made to them by the company during the income year. ***[Schedule 1, item 14, paragraph 18-135(1)(c) in Schedule 1 to the TAA 1953]***

1.98 To be subject to the tax, the associate must also have been an associate of a director, and the director a director of the company, either:

- when that company was due to pay the withheld amounts to the Commissioner but failed to do so (in full); or

- after the unpaid withholding amount became due, and 30 days later the director was still a director and the overdue PAYG withholding remained unpaid.

[Schedule 1, item 14, subsection 18-135(2) in Schedule 1 to the TAA 1953]

1.99 In the case of new directors, the associate must have been an associate of the director for the full 30-day period. ***[Schedule 1, item 14, paragraph 18-135(2)(b) in Schedule 1 to the TAA 1953]***

1.100 Employees who are not associates of a company director are not liable to pay the PAYG withholding non-compliance tax.

1.101 Merely being an associate of the director does not mean that an individual is liable to pay the tax. Two alternative tests determine this.

1.102 First, the Commissioner must also be satisfied that due to the associate's relationship with the director or their relationship with the company, that the associate knew, or could reasonably be expected to have known, that the company had failed to pay amounts withheld to the Commissioner. ***[Schedule 1, item 14, paragraphs 18-135(1)(d) and 3(a) in Schedule 1 to the TAA 1953]***

1.103 In addition to the knowledge or reasonable expectation of knowledge requirement, the Commissioner must also be satisfied that the associate did not:

- take reasonable steps to influence the director to cause the company to notify the Commissioner about the amount withheld;

- take reasonable steps to influence the director to cause the company to pay the withheld amounts to the Commissioner;

- take reasonable steps to influence the director to appoint an administrator or have the company wound up; or

- report to the Commissioner or another relevant authority (which might include the Minister, the police, and regulatory bodies including the Australian Securities and Investments Commission (ASIC)) that the company has not paid the amount withheld to the Commissioner.

[Schedule 1, item 14, paragraph 18-135(3)(b) and subsection 18-135(4) in Schedule 1 to the TAA 1953]

1.104 In determining what are 'reasonable steps' the Commissioner may have regard to:

- the length and timing of the individual's relationship with the director as an associate;
- the length and timing of the director being a director and taking part in the management of the company; and
- all other relevant circumstances.

[Schedule 1, item 14, subsection 18-135(5) in Schedule 1 to the TAA 1953]

1.105 An associate is not required to be actively involved in the company's finances to be liable to pay the PAYG withholding non-compliance tax.

Example 1.10: An associate with reasonable knowledge of a company's non-compliance

Jackson is the sole director of Onkey Pty Ltd which has not paid $200,000 of amounts withheld to the Commissioner. Lisa is married to Jackson and is employed by the company to complete ad hoc administrative work but is constantly kept up to date about the operation of the company by Jackson. She received a payment summary from the company that indicated that the company had withheld $5,000 from payments made to her.

The Commissioner is satisfied that Lisa knew that the amounts had not been paid to the Commissioner, and that she had not reported the debt to the Commissioner or another body. The Commissioner is also satisfied that she had not taken any action to encourage the payment or the winding up of the company. Therefore, Lisa is liable to pay $5,000 of PAYG withholding non-compliance tax.

Example 1.11: An associate without reasonable knowledge of a company's non-compliance

Stephen was one of eight directors of Greenfield Pty Ltd for a period of two years. During this time his son, Riley, who was 15 when his father took up the directorship, was employed by Greenfield for six months as a weekend courier. Greenfield has not paid $500,000 of amounts withheld to the Commissioner. Riley receives a payment summary from Greenfield Pty Ltd indicating that the company has withheld $400 of tax from his salary.

Assume Stephen does not have a director penalty liability.

Riley was young, and was not involved in the running of the business. Nor did Stephen talk to Riley about the details of the business. Therefore, Riley was not in a position to know of the withholding debt and there was no possibility that he could report the liability or

encourage his father to cause Greenfield to pay the Commissioner. Riley is not liable to pay the PAYG withholding non-compliance tax.

1.106 Second, where the associate was an employee of the company, the associate is liable to pay PAYG withholding non-compliance tax if the Commissioner is satisfied that the associate was treated more favourably than other company employees. ***[Schedule 1, item 14, paragraph 18-135(1)(d) and subsection 18-135(6) in Schedule 1 to the TAA 1953]***

1.107 Whether there is more favourable treatment depends on the circumstances of each case. Where there is evidence of a difference in treatment it is most likely that the associate is being treated more favourably than other employees. For example, where the associate's wage is higher than other employees doing similar work or where the associate is receiving their entitlements whilst other employees are not. Alternatively, it may be that income is being split amongst associate employees to ensure lower tax rates or other entitlements. This list is not exhaustive of the instances of favourable treatment.

Example 1.12: Favourable treatment of an associate

Mustapha is the director of Multi Co. Mustapha's wife Mariam was employed by Multi Co.

During the 2012-13 income year, Multi Co failed to make superannuation guarantee payments and some wage payments for the employees other than Mariam.

Mariam has received all of her entitlements for the year and claimed $500 of credits relating to payments made to her by Multi Co.

Multi Co has not paid $10,000 of amounts withheld to the Commissioner.

Assume Mustapha does not have a director penalty liability.

Given that Mariam is an associate of Mustapha and the Commissioner is satisfied that Multi Co has treated Mariam more favourably than the other employees, Mariam is liable to pay $500 of PAYG withholding non-compliance tax.

Amount of tax payable by an associate

1.108 Like with a director, the amount of tax payable by the associate is the lesser of:

- the total amounts withheld from payments made to the individual by the company in the individual's income year (that is, the extent that the credit is attributable to amounts

withheld from payments made by the company of which the individual was an associate of a director); and

- the company's PAYG withholding liability for payments made during the income year.

[Schedule 1, item 14, subsection 18-135(7) in Schedule 1 to the TAA 1953]

When tax is payable for an associate

1.109 The due and payable date for an associate's PAYG withholding non-compliance tax is the same as for directors (see paragraph 1.77). ***[Schedule 1, items 14 and 15, subsection 250-10(2) and section 18-145 in Schedule 1 to the TAA 1953]***

1.110 The imposition of GIC on an associate's overdue PAYG withholding non-compliance tax is also the same as for directors (see paragraph 1.78). ***[Schedule 1, items 12 and 14, subsection 8AAB(4) of the TAA 1953 and section 18-150 in Schedule 1 to the TAA 1953]***

Recovering unpaid PAYG withholding non-compliance tax

1.111 If a company director or their associate is liable to pay PAYG withholding non-compliance tax, or GIC on that tax, and they have failed to do so, the Commissioner may only commence proceedings to recover the tax after issuing a notice to the individual. ***[Schedule 1, item 14, subsection 18-140(1) in Schedule 1 to the TAA 1953]***

1.112 The Commissioner must not issue a notice of PAYG withholding non-compliance tax to a director if that director has a director penalty liability that relates to the company's failure to meet its PAYG withholding obligations. ***[Schedule 1, item 14, subsection 18-140(3) in Schedule 1 to the TAA 1953]***

1.113 The Commissioner must not issue a notice to an associate if the director of whom the individual is an associate has a director penalty liability that relates to the company's failure to meet its PAYG withholding obligations. ***[Schedule 1, item 14, subsection 18-140(3) in Schedule 1 to the TAA 1953]***

Notices

1.114 The notice must specify the company that the PAYG withholding non-compliance tax relates to, the income year of the individual and the amount of PAYG withholding non-compliance tax the individual is required to pay. ***[Schedule 1, item 14, subsection 18-140(4) in Schedule 1 to the TAA 1953]***

1.115 If, on the basis of the information available to the Commissioner, the Commissioner is satisfied that it is fair and reasonable for the individual to pay the PAYG withholding non-compliance tax, the Commissioner may issue a notice. ***[Schedule 1, item 14, subsection 18-140(2) in Schedule 1 to the TAA 1953]***

1.116 A notice given by the Commissioner to the individual director or their associate in order to recover an amount of unpaid PAYG withholding non-compliance tax is taken to be conclusive evidence of the making of the notice and that the amount and all particulars of the notice are correct. The only exception in regard to the amount and particulars is for objection and review proceedings under Part IVC of the TAA 1953. ***[Schedule 1, item 14, subsection 18-155(2) in Schedule 1 to the TAA 1953]***

1.117 A notice given by the Commissioner is valid even if the Commissioner has not complied with a provision of the Act, such as a procedural requirement under the Act. ***[Schedule 1, item 14, subsection 18-155(1) in Schedule 1 to the TAA 1953]***

1.118 These types of provisions are standard provisions in the tax law to facilitate the collection of tax. ***[Schedule 1, item 14, sections 18-145 to 18-155 in Schedule 1 to the TAA 1953]***

The company complies, or partially complies, before the notice day

1.119 If the company has paid some or all of their unpaid PAYG withholding liability after the day it was due but before the Commissioner issues a notice to enable recovery, the amount of the tax that is recoverable from the individual is reduced as a result. ***[Schedule 1, item 14, subsections 18-140(5) to (7) in Schedule 1 to the TAA 1953]***

1.120 If the discharge of the company’s liability means that no tax would have been payable by the individual had the discharge occurred before the day the company was required to pay the amounts withheld to the Commissioner, the individual’s amount of tax is reduced to nil and treated as always having been nil. ***[Schedule 1, item 14, subsection 18-140(5) and paragraph 18-140(6)(a) in Schedule 1 to the TAA 1953]***

1.121 However, if the discharge of the company’s liability would have only reduced the amount of PAYG withholding non-compliance tax payable by the individual (had the discharge occurred before the company was required to pay PAYG withholding to the Commissioner), the individual’s tax is reduced.

1.122 The reduction is by the amount that the original amount of PAYG withholding non-compliance tax exceeds the amount that would have been payable, had the discharge occurred before the due day for the company paying its PAYG withholding to the Commissioner. ***[Schedule 1,***

item 14, subsection 18-140(5) and paragraph 18-140(6)(b) in Schedule 1 to the TAA 1953]

1.123 Again, the reduced amount is treated as always having been the amount of PAYG withholding non-compliance tax payable by the individual. ***[Schedule 1, item 14, subsection 18-140(7) in Schedule 1 to the TAA 1953]***

The company complies after a recovery notice has been issued

1.124 A company may pay some or all of its PAYG withholding liability after the individual director or an individual associate of the director has become liable to pay an amount of PAYG withholding non-compliance tax.

1.125 If this occurs after the Commissioner issues a notice to enable recovery of the PAYG withholding non-compliance tax from the individual, the individual may be entitled to a credit. ***[Schedule 1, item 14, section 18-165 in Schedule 1 to the TAA 1953]***

1.126 To work out if the individual is entitled to a credit, the Commissioner must replace the amounts originally used to determine the amount of tax payable with amounts worked out taking into account the company's repayment. Where the new circumstances do not impact on the amount of tax payable by the individual, the Commissioner is not required to provide the individual a credit, although a discretion to do so exists. In determining whether to exercise that discretion the Commissioner must have regard to what is fair and reasonable in the circumstances.

1.127 If the Commissioner exercises that discretion, the amount of the credit entitlement must not exceed either the amount of PAYG withholding non-compliance tax payable by the individual, or the amount of the discharge. ***[Schedule 1, item 14, section 18-175 in Schedule 1 to the TAA 1953]***

Example 1.13: A later payment of the PAYG withholding liability with no impact on an entitlement to credits

Danielle is the sole director of Tucker Pty Ltd. Danielle was entitled to a credit of $5,000 for amounts withheld from payments made to her by Tucker Pty Ltd during the 2013-14 income year. Tucker Pty Ltd had an unpaid withholding liability of $10,000 for amounts due in that income year.

Assume Danielle did not have a director penalty liability. Therefore, Danielle was liable to pay $5,000 PAYG withholding non-compliance tax.

> The Commissioner was satisfied that it was fair and reasonable for Danielle to pay the PAYG withholding non-compliance tax and issued a notice to enable recovery of the tax.
>
> After this occurred, Tucker Pty Ltd made a payment of $3,000 toward its withholding liability. As a result the Commissioner reconsidered Danielle's requirement to pay the tax.
>
> Because the company debt after the partial repayment ($7,000) still exceeds Danielle's original entitlement to credits ($5,000), the Commissioner is not required to take any action.

1.128 If, under the new circumstances, the amount of PAYG withholding non-compliance tax that would have been payable by the individual is less than under the original circumstances (including if the amount payable would have been nil), the Commissioner must issue a notice to the individual. ***[Schedule 1, item 14, subsection 18-170(1) in Schedule 1 to the TAA 1953]***

1.129 An individual is entitled to a credit if the Commissioner issues a notice and becomes entitled to the credit on the day the notice is issued. ***[Schedule 1, item 14, subsections 18-170(2) and (3) in Schedule 1 to the TAA 1953]***

1.130 The amount of the credit is the amount stated in a notice issued by the Commissioner. ***[Schedule 1, item 14, subsection 18-170(4) in Schedule 1 to the TAA 1953]***

1.131 If, under the new circumstances, the individual would not have been required to pay the PAYG withholding non-compliance tax because the company debt no longer existed, the value of the entitlement must be equal to the original amount of PAYG withholding non-compliance tax. ***[Schedule 1, item 14, subsections 18-170(4) and (5) in Schedule 1 to the TAA 1953]***

1.132 Where the new circumstances lead only to a reduction in the amount of PAYG withholding non-compliance tax that would have been payable by the individual, the amount of the credit entitlement is determined by the Commissioner, having regard to what is fair and reasonable in the circumstances.

1.133 However, the credit entitlement must not be more than the original amount of PAYG withholding non-compliance tax or the amount of the company's discharge. The amount also must not be less than the amount by which the original PAYG withholding non-compliance tax exceeds the amount of tax that would have been payable had the company's discharge occurred before the notice was issued. ***[Schedule 1, item 14, subsections 18-170(6) and (7) in Schedule 1 to the TAA 1953]***

Example 1.14: A later payment of a PAYG withholding liability resulting in an entitlement to credits

> Fran is the sole director of Scott Pty Ltd. For the 2012-13 income year Fran is entitled to a credit of $15,000 for amounts withheld from payments made to her by Scott Pty Ltd. As Scott Pty Ltd had a PAYG withholding liability of $20,000, and assuming Fran does not have a director penalty liability, the Commissioner issues Fran a notice. Fran is liable to pay $15,000 PAYG withholding non-compliance tax.
>
> After this occurred, Scott Pty Ltd pays $18,000 of its PAYG withholding liability to the Commissioner.
>
> Accordingly, the Commissioner must consider the impact on Fran's requirement to pay PAYG withholding non-compliance tax.
>
> Because the original amount of tax ($15,000) exceeds the revised company debt ($2,000) Fran is entitled to a partial credit.
>
> The Commissioner must provide Fran with a credit of at least $13,000, which is the amount by which the original amount of tax exceeds the company's revised debt.
>
> The revised company withholding debt is used to calculate the credit entitlement because, had Scott Pty Ltd made the payment before Fran's credits were reduced, the amount of tax payable by Fran would have been equal to Scott Pty Ltd's debt ($2,000) as it was less than Fran's credits.

1.134 The company may make numerous part-payments of its debt and, as a result, the individual may be entitled to a credit due to the Commissioner providing a notice. Where this has occurred, any reference to an amount of PAYG withholding non-compliance tax for the purpose of notices for later compliance, is treated as the amount of the tax, reduced by the total of credits to which an individual is already entitled because of earlier notices. Once the company has paid all of its withheld amounts to the Commissioner, all of the directors (and any associates that have been impacted) are entitled to a credit equal to the original amount of PAYG withholding non-compliance tax they were liable to pay. ***[Schedule 1, item 14, sections 18-170, 18-175 and 18-180 in Schedule 1 to the TAA 1953]***

1.135 In accordance with existing law, the credit or credits may be offset against existing debts, such as a PAYG withholding non-compliance tax debt, or, if their PAYG withholding non-compliance tax has been paid, it may entitle the individual to a refund.

1.136 The purpose of making a director or their associate entitled to a credit where the company has subsequently paid withheld amounts is to encourage company directors to cause their companies to comply.

1.137 Where a company has debts other than PAYG withholding liabilities, the Commissioner has a broad discretion (under Division 3 of Part IIB of the TAA 1953) as to how payments or credits are applied. The Commissioner's existing practice statement explains the order in which payments and credits are applied against debts of various types.

1.138 An individual's entitlement to a credit as a result of the company making late payments of withheld amounts to the Commissioner does not entitle the individual to interest on the credit. This avoids providing an incentive for companies to pay withheld amounts after they are required to by the law. ***[Schedule 1, items 17 to 19, subsections 3(1) and (3) of the Taxation (Interest on Overpayments and Early Payments) Act 1983]***

Timing of notices

1.139 Notices issued for the purpose of enabling the Commissioner to collect the PAYG withholding non-compliance tax can be issued no later than two years after the notice of assessment for the individual's income tax for that income year is issued. ***[Schedule 1, item 14, paragraph 18-185(b) in Schedule 1 to the TAA 1953]***

1.140 Notices that show an increase in the amount of PAYG withholding non-compliance tax payable (for example, through an amendment to a notice that reduces tax) or a notice that decreases or disentitles an individual's credit entitlement (for example, through an amendment to a credit entitlement notice) can be issued no later than two years after a notice of assessment is given. ***[Schedule 1, item 14, paragraph 18-185(6) in Schedule 1 to the TAA 1953]***

1.141 Notices that result in a reduction in the amount of PAYG withholding non-compliance tax payable, or that entitle an individual to a credit (or increase a credit entitlement) can be issued no later than four years after the notice of assessment for the individual's income tax for that income year is issued. ***[Schedule 1, item 14, paragraph 18-185(c) in Schedule 1 to the TAA 1953]***

1.142 If no notice of assessment for the individual's income tax for that income year has been issued, or if the notice is to give effect to a decision on a review or appeal or because of an objection made by the individual or pending a review or appeal, there is no time limit of the Commissioner issuing a notice of any sort. ***[Schedule 1, item 14, paragraphs 18-185(a) and (d) in Schedule 1 to the TAA 1953]***

1.143 The longer period for notices that reduce the tax payable or entitle an individual to a credit (or a greater credit) also allows a greater period for individuals to benefit from the company later meeting its obligation to pay its PAYG withholding liability to the Commissioner.

Review of decisions

1.144 A director or an associate who receives a notice enabling the Commissioner to recover an amount of PAYG withholding non-compliance tax may object against any decision the Commissioner has made under section 18-130, 18-140, 18-170, or 18-175. This includes decisions in relation to:

- reducing the amount of tax payable by a director;
- issuing a notice to enable recovery of the tax; or
- entitling the individual to a credit (and the amount of the credit).

[Schedule 1, item 14, section 18-190 in Schedule 1 to the TAA 1953]

1.145 Where a director or associate succeeds in a review of a Commissioner's decision to reduce the tax or a Commissioner's decision to issue a notice to enable recovery, the taxpayer could be entitled to interest.

Right of indemnity and contribution

1.146 The treatment of directors under the PAYG withholding non-compliance tax provisions is consistent with that under the director penalty regime — directors effectively have joint and several liability.

1.147 To deal with the potential unfairness associated with recovering different amounts from company directors (as a consequence of their original credit entitlement being lower than other directors and therefore the amount of PAYG withholding non-compliance tax payable also being lower), a right of indemnity and contribution allows directors to recover the amounts they have paid from the company or other directors. ***[Schedule 1, item 14, section 18-160 in Schedule 1 to the TAA 1953]***

1.148 A director whose PAYG withholding non-compliance tax was reduced by the Commissioner because the Commissioner was satisfied that the director was not, to some extent, responsible for the company's non-compliance, has their responsibility to contribute to other directors reduced to the same extent. ***[Schedule 1, item 14, subsection 18-160(4) in Schedule 1 to the TAA 1953]***

Example 1.15: Directors seeking contributions from each other

Wilhelm and Aislinn are the directors of Rainbow Co. In the 2013-14 income year, Rainbow Co had a PAYG withholding liability of $50,000. (Assume neither Wilhelm nor Aislinn have director penalty

liabilities.) Wilhelm's credit entitlement attributable to amounts withheld by Rainbow Co was $15,000, making Wilhelm liable to pay $15,000 PAYG withholding non-compliance tax. Aislinn's credits attributable to amounts withheld by Rainbow Co was $20,000, making her liable to pay $20,000 PAYG withholding non-compliance tax.

Wilhelm and Aislinn have rights of indemnity and contribution against Rainbow Co, and may seek compensation for their respective liabilities for PAYG withholding non-compliance tax.

They also have rights of indemnity and contribution against each other.

1.149 Associates who are liable to PAYG withholding non compliance tax have rights of indemnity and contribution, allowing them to seek indemnity and contribution for the tax they have paid from the company or the company's directors.

1.150 There is no right of indemnity or contribution against an associate, either by directors or by other associates. ***[Schedule 1, item 14, subparagraph 18-160(2)(b)(ii) in Schedule 1 to the TAA 1953]***

Example 1.16: An associate seeking a contribution from a director

Matt is a director of Kingsgate Pty Ltd. In the 2013-14 income year, Kingsgate Pty Ltd had a PAYG withholding liability of $10,000 (assume Matt does not have a director penalty liability). Matt was liable to pay $8,000 PAYG withholding non-compliance tax. The Commissioner was also satisfied that Matt's associate Pam, was liable to pay $2,000 PAYG withholding non-compliance tax.

Matt and Pam have rights of indemnity and contribution against Kingsgate Pty Ltd, and may seek compensation for their respective liabilities for PAYG withholding non compliance tax.

Pam also has a right of indemnity and contribution against Matt.

However, Matt does not have a right of indemnity and contribution against Pam as she is not a director of Kingsgate Pty Ltd.

1.151 The right of indemnity and contribution is an important aspect of ensuring that any one individual, particularly an associate, is not solely responsible for the financial burden caused by the company's failure to comply with its obligations.

Application and transitional provisions

1.152 The amendments to extend the director penalty regime to superannuation guarantee charges apply to a company's liability for a

quarter if the day by which the company must lodge a superannuation guarantee statement for the quarter occurs on or after Royal Assent. ***[Schedule 1, item 57]***

1.153 The amendments to the estimates regime apply to superannuation guarantee charge for a quarter if the day by which you must lodge a superannuation guarantee statement for the quarter occurs on or after the day of Royal Assent. ***[Schedule 1, item 47]***

1.154 An estimate in force just before Royal Assent has effect from Royal Assent as if it had been made as amended by this Schedule. ***[Schedule 1, item 46]***

1.155 The amendments to the director penalty notice and defence requirements apply to penalties due at or after this Bill receives Royal Assent. ***[Schedule 1, item 4]***.

1.156 The rules particular to new directors apply if a director becomes a director and begins to be under an obligation on or after the day this Bill receives Royal Assent. ***[Schedule 1, item 7]***

1.157 The rules regarding the effect of a directors' obligation ending before the end of the notice period, and restricting the remission options available to directors after a director penalty has been unpaid and unreported for three months apply if the directors of the relevant company stop being under the relevant obligation on or after the day this Bill receives Royal Assent. ***[Schedule 1, item 9]***

1.158 The amendments for reduction of credits to directors and associates apply to amounts withheld during the 2011-12 income year and later income years, if the company withholding the amounts is required to pay them to the Commissioner on or after the day after this Bill receives Royal Assent. ***[Schedule 1, item 23]***

Consequential amendments

1.159 The consequential amendments to the *Corporations Act 2001* reflect changes associated with the extension of the estimates regime and director penalty regime to the superannuation guarantee charge to ensure consistent treatment of superannuation guarantee charge amounts regardless of how they are quantified or collected. ***[Schedule 1, items 24 to 34]***

1.160 A consequential amendment to the ITAA 1997 instructs taxpayers on how to treat the PAYG withholding tax for the purpose of the alienation of personal services income. ***[Schedule 1, item 10, subsection 86-40(2) of the ITAA 1997]***

Applying payments and credits against unquantified director penalties

1.161 Under the existing payment and crediting rules in Division 3 of Part IIB of the TAA 1953 the Commissioner must treat a payment or credit using one of two methods (allocating the amount first to a running balance account or applying the amount first against a non-running balance account). Although this gives the Commissioner considerable discretion as to how a payment or credit is applied, prima facie there is no discretion not to apply a payment or credit (except in three specified cases).

1.162 Amendments to the payment and crediting rules give the Commissioner a discretion not to treat the amount of a payment or credit using either of the stipulated methods if doing so would require him to apply that amount against a director penalty. A discretion is being included for director penalties because of their unusual nature of being ‘parallel liabilities’. That is, the relevant company has an underlying liability for an equivalent amount (and other directors also have a liability for an equivalent amount). Consequently, where an individual has a director penalty liability and is entitled to a credit, the Commissioner is not compelled to apply that credit against the director penalty liability, although the credit can be applied under the rules in Division 3 of Part IIB in the TAA 1953. ***[Schedule 1, item 1, subsection 8AAZL(4) of the TAA 1953]***

STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS

Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

Companies’ non-compliance with PAYG withholding and superannuation guarantee obligations

1.163 This Schedule is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview

1.164 This Schedule amends the TAA 1953 by:

- extending the director penalty regime to make directors personally liable for their company's unpaid superannuation guarantee amounts;

- ensuring that directors cannot discharge their director penalties by placing their company into administration or liquidation when PAYG withholding or superannuation guarantee remains unpaid and unreported three months after the due date; and
- in some instances, making directors and their associates liable to PAYG withholding non-compliance tax (effectively reducing credit entitlements) where the company has failed to pay amounts withheld to the Commissioner.

1.165 The tax on directors and their associates is imposed by the Pay As You Go Withholding Non-compliance Tax Bill 2012

Human rights implications

1.166 This Schedule and the Pay As You Go Withholding Non-compliance Tax Bill 2012 do not engage any of the applicable rights or freedoms.

Conclusion

1.167 This Schedule and the Pay As You Go Withholding Non-compliance Tax Bill 2012 are compatible with human rights as they do not raise any human rights issues.

Assistant Treasurer, the Hon David Bradbury MP

REGULATION IMPACT STATEMENT

Introduction

1.168 During the 2010 election campaign, the Australian Labor Party (ALP) committed to address fraudulent phoenix activity. In particular, the ALP committed to:

- legislate to automate the current director penalty regime so that it automatically applies three months after payment to the Commissioner was due if the company does not report its outstanding liability;

- provide the ATO with the authority to stop directors and their associates accessing PAYG withholding credits in their own tax returns where their company has not made the PAYG withholding payments to the ATO; and
- extend the director penalty regime to include superannuation guarantee payments.

1.169 A Schedule to enact these measures was included in Tax Laws Amendment (2011 Measures No. 8) Bill 2011, which was introduced to Parliament in Spring 2011. However, following recommendations from the House of Representatives Standing Committee on Economics, the Government removed these measures from Tax Laws Amendment (2011 Measures No. 8) Bill 2011 in order to conduct further consultation. As a result of that consultation, the Government amended its policy such that the director penalty regime would not be automated. Instead, in all cases the Commissioner will issue a director penalty notice before commencing recovery proceedings. However, the remission options available to directors for amounts unpaid and unreported after three months will still be limited so that directors will not be able to avoid personal liability for director penalties after three months by placing their company into administration or beginning to wind it up.

1.170 These policy outcomes are achieved by legislative amendment to the TAA 1953.

1.171 Stopping directors and their associates accessing PAYG withholding credits is achieved by making directors and their associates liable to PAYG withholding non-compliance tax where the company has failed to pay amounts withheld under the PAYG withholding regime to the Commissioner. The director or associate must also have a credit that is attributable to amounts withheld from payments made to them by the relevant company.

1.172 Further criteria apply for a liability to arise for an associate. For both associates and directors, the Commissioner cannot commence recovery where the relevant director is under a director penalty liability.

1.173 Making company directors personally liable for their company's unpaid superannuation guarantee amounts is achieved by extending the director penalty regime to the superannuation guarantee charge.

What is fraudulent phoenix activity?

1.174 Fraudulent phoenix activity involves the accumulation of debts in a corporate structure and the liquidation of that company to avoid

liability for those debts. It is important to distinguish such activity from honest behaviour.

1.175 Corporate law in Australia has traditionally reinforced the values of entrepreneurship and commercial risk taking, which are seen to be fundamental to wealth creation and a well-functioning market. Directors and shareholders are encouraged to engage in entrepreneurship and risk taking by limited liability, which can protect them from the costs associated with a company's failure.

1.176 A genuine business failure where the business has been managed responsibly and subsequently continues using another corporate entity is not of itself an illegitimate use of the corporate form. This use of the corporate form should be contrasted with dishonest practices that abuse the corporate form and the privilege of limited liability as a means of generating personal wealth or an unfair competitive advantage. Such arrangements may be used to avoid debts, including debts to other creditors, the ATO and employees.

1.177 Fraudulent phoenix activity can take a variety of forms. In its most basic form, fraudulent phoenix activity may include accumulating debts without any intention of repaying those debts (for the purpose of wealth creation or to boost the cash flow of the business) and liquidating to avoid repaying the debt. The business then continues in another corporate entity, controlled by the same person or group of individuals.

1.178 However, fraudulent phoenix activity can often be more sophisticated, for example, arrangements involving a number of companies controlled by the same person. One company will hold the assets and wealth for the group while another company provides services. The service company may be liquidated and replaced with little disruption to the day-to-day operation of the overall business and the financial benefits from the unpaid liabilities are shared amongst the wider group. The services company has little or no assets to cover the company's debts (including employee entitlements).

1.179 Because of the variety of structures that phoenix activity can take and the need to protect entrepreneurialism, fraudulent phoenix activity is inherently difficult to define. However, underlying the distinction between illegitimate, or fraudulent, phoenix activity and a legitimate use of the corporate form is the intention for which the activity is undertaken.

Impact of fraudulent phoenix activity

1.180 Phoenix activity has a significant impact on employee entitlements, government tax revenue collections and the economy more generally. Although it is difficult to measure precisely the cost of fraudulent phoenix activity, in 1996 the Australian Securities Commission (now the Australian Securities and Investments Commission) estimated the annual loss to the Australian economy due to phoenix activity as $670 million to $1.3 billion (Australian Securities Commissioner 1996, Research Paper No 95/01 — *Phoenix Companies and Insolvent Trading*, Canberra).

1.181 This figure is likely to have grown as the ATO reports that, although fraudulent phoenix activity has historically been most prevalent with small business, that is, those businesses with a turnover below or around $2 million, fraudulent phoenix activity is being undertaken by much larger businesses and by individuals who already have significant levels of wealth.

1.182 Concern over the spread of fraudulent phoenix activity to a wider range of businesses and across more industries is also heightened by the apparent increase in the numbers of individuals promoting the benefits of fraudulent phoenix activity. This was noted by the Joint Committee of Public Accounts and Audit in its report on tax administration tabled on 26 June 2008 (Joint Committee of Public Accounts and Audit 2008, *Report 410 into Tax Administration*, Canberra).

1.183 The ATO estimates that the current stock of phoenix activity that it is monitoring poses a risk to revenue of around $600 million.

1.184 In the past the biggest impact on the revenue has come from phoenix companies which fail to pay to the Commissioner amounts withheld under the PAYG withholding system. These funds relate to the tax liability of a particular employee and it is as if the employer holds these funds 'on trust'. Such funds should never become part of the cash-flow of a business. However, the tax law does not make the employee liable for unpaid PAYG withholding amounts. In fact, under the existing law, the ATO cannot even pursue the outstanding PAYG withholding in relation to the salary and wages of the director of a phoenix company.

1.185 Fraudulent phoenix operators may also avoid other tax liabilities, such as the goods and services tax (GST) and the superannuation guarantee. The non-payment of superannuation guarantee is of particular concern as, unlike other liabilities imposed under Australia's taxation laws, it will result in a direct loss to the individual employee.

1.186 In addition, fraudulent phoenix operators may fail to pay employees' redundancy entitlements, outstanding leave entitlements and voluntary superannuation contributions. The Government has committed to provide further protection for employees through the Fair Entitlements Guarantee.

1.187 Many fraudulent phoenix operators also leave debts to other creditors, such as suppliers of goods. These creditors receive some protection from the fact that, unlike the ATO and employees, they have the power to refuse credit or to require a personal guarantee from the directors.

1.188 Phoenix operators also impact on the efficient operation of the market because they can offer lower prices for their goods and services because they intend to avoid the tax and other liabilities associated with the project.

Problems with the existing law

1.189 The existing taxation law includes a number of features that can be used to address fraudulent phoenix activity. However, they have some limitations.

The director penalty regime

1.190 The director penalty regime encourages a company director to cause the company to pay outstanding PAYG withholding amounts or enter into voluntary administration by making the director(s) personally and severally liable for those outstanding amounts if the ATO has given written notice to the director. The director can avoid liability by causing the company to do one of the following four things within 21 days of receiving the notice:

- comply with its obligations in relation to paying the PAYG withholding amounts;
- enter into a payment agreement with the Commissioner in relation to the amounts;
- appoint an administrator of the company; or
- wind up the company.

1.191 The director will not be held personally liable for the debt if one of the defences in section 269-35 in Schedule 1 to the TAA 1953 is satisfied. These defences are:

- non-participation in the management of the company because of illness or some other good reason; and
- taking all reasonable steps to achieve compliance unless no such steps were available.

1.192 The ability of the director penalty regime to address fraudulent phoenix activity is limited by a number of factors. Notably:

- issuing director penalty notices to make a director's debt recoverable is highly resource intensive and, as a result, they are issued only to a small percentage of the directors who are liable to a director penalty;
- there may be a time lapse between the company's non-compliance and the ATO issuing the director penalty notices because the ATO must first identify that the company has an outstanding PAYG withholding liability (which is often hindered by the company failing to report its PAYG withholding liability) and then identify who the directors are (in consultation with ASIC), allowing the company to accumulate additional debts before taking action; and
- as the regime focuses only on PAYG withholding liabilities, it does not provide any disincentive for fraudulent phoenix operators to accrue other liabilities, such as superannuation guarantee payments.

1.193 A company that fails to report is currently liable to a criminal penalty of 20, 40 or 50 penalty units (see sections 8C and 8E, and sections 16-150 and 16-153 in Schedule 1 to the TAA 1953). Section 8Y of the TAA 1953 allows directors to be pursued personally for such penalties. However, such criminal penalties are often negligible compared to the outstanding tax liabilities. In addition, section 8Y of the TAA 1953 is currently being reviewed as part of a Council of Australian Governments review of provisions that make directors criminally liable for the conduct of companies. It is not feasible to enforce such a penalty against a phoenix company because they are likely to be in liquidation with limited funds to pay such penalties.

PAYG withholding credits

1.194 An individual who has had amounts withheld through the PAYG withholding system is entitled to a credit for those amounts, irrespective of whether they have been paid to the Commissioner. Indeed the usual practice of the Commissioner is to allow a taxpayer credit upon assessment for amounts withheld substantiated by a payment summary completed by the payer or a statutory declaration in lieu.

1.195 While a credit cannot be denied for amounts that have not been paid to the Commissioner, the Commissioner does deny credits on the basis that an amount was not withheld in the first place. In the context of fraudulent phoenix activity the Commissioner's current practice is to deny the credit where the payee is a director of the paying entity and the Commissioner has evidence to support the view that moneys were not actually withheld.

1.196 However, the ability of the Commissioner to deny directors unpaid PAYG withholding credits is limited.

- It is relatively difficult for the Commissioner to obtain evidence that an amount was not withheld, particularly where the Commissioner is presented with a completed payment summary that suggests otherwise. It is relatively easy to prove that an amount was not paid to the Commissioner, which is readily apparent from the absence of a payment to the Commissioner.

- Conducting prosecutions for fraudulent conduct under the *Crimes Act 1914* and the *Criminal Code Act 1995* provides some disincentive to engage in such behaviour. However, such prosecutions generally require the involvement of the Australian Federal Police and the Commonwealth Director of Public Prosecutions, are highly resource intensive and can take several years to be finalised.

The desired objectives

1.197 The objective of these reforms is to reduce the incentives for company directors to allow their companies to engage in fraudulent phoenix activity, reducing its impact on the community. The reforms also aim to better protect workers' entitlements to superannuation. There should be sufficient deterrents in the tax law to discourage directors from undertaking fraudulent phoenix activity with the intention of the company

avoiding its tax and superannuation obligations or avoiding the company's obligations to creditors more generally.

Implementation options

1.198 The *Action Against Fraudulent Phoenix Activity* proposals paper, which was released by the Government for public consultation on 14 November 2009 set out a number of taxation law and corporations law options for addressing fraudulent phoenix activity. Taxation law options include:

- automating the director penalty regime;
- extending the director penalty regime to other taxes;
- amending the promoter penalty regime;
- expanding the anti-avoidance provisions;
- re-instating the failure to remit offence;
- denying PAYG withholding credits to directors and their close associates;
- creating offences for claiming PAYG withholding credits that had not been paid to the Commissioner; and
- extending the bond provision.

1.199 Corporations law options included:

- expanding the scope for disqualifying directors;
- restricting the use of similar names by successor companies; and
- adopting a doctrine of inadequate capitalisation.

1.200 As set out above, during the 2010 election campaign the Government committed to address fraudulent phoenix activity by:

- extending the director penalty regime to include the superannuation guarantee;
- amending the current director penalty regime so that it automatically applies after three months (this, however, has

been modified such that the Commissioner will need to issue a director penalty notice in all instances, and the remission options available to directors are now restricted after three months – directors will not be able to avoid personal liability for director penalties after three months by placing their company into administration or beginning to wind it up; and

- providing the ATO with the authority to stop directors and their associates accessing PAYG withholding credits in their own tax returns where their company has not made the PAYG withholding payments to the ATO.

1.201 The Government also announced that it would restrict the use of similar names by successor companies and further examine:

- extending the promoter penalty regime to include schemes to avoid payment of tax; and
- extending the director penalty regime to indirect taxes.

Expanding the director penalty regime to apply to unpaid superannuation guarantee liabilities

1.202 Under the Government's election commitment, the existing director penalty regime would be extended to include unpaid superannuation guarantee liabilities (that is, the superannuation guarantee charge payable to the ATO because the company has not met their superannuation guarantee obligations to an employee).

1.203 The director penalty regime is sometimes seen as draconian because it makes directors personally liable for the debts of the company.

1.204 Extending the director penalty regime to the superannuation guarantee charge is appropriate because the superannuation guarantee is similar to PAYG withholding in that the amounts represent the entitlements of employees. In the case of PAYG withholding amounts, the Government will give the employee a credit regardless of the amount collected from the company. However, in the case of the superannuation guarantee the Government will only credit an employee's superannuation fund when the amount is recovered from the company.

1.205 The Commonwealth Ombudsman estimates that 10 per cent of complaints about tax administration last year related to the ATO's inability to recover unpaid superannuation. Extending the director penalty regime to the superannuation guarantee will discourage phoenix operators from using employee entitlements to disguise the company's cash flow issues and generally discourage fraudulent phoenix activity.

Limited remission options after three months

1.206 As set out above, the existing director penalty regime makes a director personally liable for a company's outstanding PAYG withholding. The penalty is recoverable by the Commissioner 21 days after issuing a director penalty notice if the director has not caused the company to pay the debt, or placed the company into administration or liquidation. The director's ability to put-off payment of the penalty indefinitely until they receive a notice, and then to avoid liability absolutely by liquidating the company is a significant limitation on the effectiveness of the director penalty regime.

1.207 Therefore, if a director penalty has been outstanding for three months when a director is served with a director penalty notice, the director will not be able to remit that penalty by placing the company into administration or liquidation. The director will remain personally liable to pay the amount of the penalty, unless he or she causes the company to comply with its obligation. As under the existing law the Commissioner will have to give a notice of the penalty to the director before commencing recovery proceedings.

1.208 Directors will still be able to avoid personal liability if they were not involved in the management of the company, took all reasonable steps to cause compliance (or no such steps were available), or put the company into administration or liquidation before the three-month period expires. Directors also have a right of indemnity against the company for such debts.

1.209 The three-month time frame is considered appropriate as it prevents companies accruing large debts before directors are held personally liable.

Denying PAYG withholding credits

1.210 Under the Government's election commitment, PAYG withholding credits would be denied to directors and their associates if the company failed to pay amounts withheld under PAYG withholding to the Commissioner.

1.211 To achieve this outcome, directors are liable to PAYG withholding non-compliance tax where the company has failed to pay the total of the amount withheld during the income year to the Commissioner. The director must also have a credit that is attributable, to an extent, to an amount withheld from a payment made to the director by the company.

1.212 The amount of PAYG withholding non-compliance tax that a director is liable to pay is the lesser of the extent to which a credit is attributable to an amount withheld from a payment made to the director by the company or the company's PAYG withholding liability. This cap on the amount of the tax effectively ensures that the consequence is a denial of the director's credit. In cases where the company debt is less than the director's credit, the outcome would effectively be a partial denial of the credit.

1.213 Where a director can satisfy the Commissioner that they were not involved in the management of the company (and there was a good reason for that lack of involvement), that they took all reasonable steps to cause the company to comply or no such reasonable steps were available, a defence is made out and the amount of tax payable will be reduced.

1.214 An associate is liable to PAYG withholding non-compliance tax where the company has failed to pay the total of the amount withheld during the income year to the Commissioner. The associate must also have a credit that is attributable to an extent to an amount withheld from a payment made to the associate by the company. In addition, the Commissioner must be satisfied that the associate had knowledge of the company's non-compliance (or could reasonably be expected to have that knowledge) and did not take appropriate actions to cause the company to pay the withholding, or to bring it to the attention of authorities.

1.215 Again, the amount of PAYG withholding non-compliance tax that an associate is liable to pay is the lesser of the extent to which a credit is attributable to an amount withheld from a payment made to the associate by the company or the company's PAYG withholding liability. This effectively results in a denial of credits for associates of directors.

1.216 For both directors and their associates, the Commissioner is not able to commence proceedings to recover the tax where the relevant director has a director penalty liability.

Assessment of impacts

1.217 The proposal is expected to result in a net benefit to the community. The potential compliance costs to businesses are small compared to the benefits associated with addressing fraudulent phoenix activity.

Analysis of benefits

Businesses

1.218 These proposals benefit businesses that comply with their tax and superannuation obligations and put them on an even playing field with companies that might otherwise seek to engage in phoenix behaviour to obtain a competitive price advantage for the provision of goods and services to customers.

1.219 Limiting the remission options after three months will encourage directors to address solvency issues earlier.

Employees

1.220 Expanding the director penalty regime to superannuation guarantee amounts will improve the likelihood that employees will be paid their superannuation entitlements. As the Government only provides credits for the amount actually collected, the possibility that directors will become personally liable for unpaid superannuation guarantee amounts provides an incentive for companies to comply with their superannuation obligations. The higher the level of compliance, the greater the amount of superannuation credits that employees will be able to access.

ATO

1.221 These proposals are designed to strengthen the powers of the ATO to recover PAYG withholding and superannuation guarantee liabilities, including from phoenix operators.

1.222 It is anticipated that the changes will also increase voluntary compliance.

1.223 The ATO estimates that the current stock of phoenix activity that it is monitoring poses a risk to revenue of around $600 million.

Creditors

1.224 Limiting the remission options available to directors after three months, and extending the director penalty regime to superannuation guarantee liabilities is likely to encourage company directors to address their solvency issues in a timelier manner and will prevent them from using PAYG withholding and superannuation guarantee amounts to disguise cash flow problems.

1.225 The proposed changes to the director penalty regime and the potential financial impacts on directors personally should encourage them

to treat their company's solvency issues more seriously and discourage directors from pursuing fraudulent phoenix activities.

1.226 Removing incentives to undertake fraudulent phoenix activity would reduce the extent to which debt can be accumulated in a phoenix company. As such, not only will smaller debts be owed to creditors (including employees and the ATO) at the time of liquidation, but the nature of the company (and its successors) as a fraudulent phoenix company will become more readily apparent to creditors, who may then take action to protect themselves.

1.227 The amendments provide more incentive for directors to focus on the solvency of their company and therefore the company will be in a better position to manage potential debts to creditors.

Community

1.228 Although it is difficult to measure precisely the cost of fraudulent phoenix activity, in 1996 the Australian Securities Commission (now ASIC) estimated the annual loss to the Australian economy due to phoenix activity as $670 million to $1.3 billion.

1.229 These proposals are expected to provide a revenue gain of $300 million over the five-year period 2011-12 to 2015-16.

1.230 In addition to improving worker's access to entitlements, the community at large will benefit from the collection of tax debts and improved tax compliance. The proposals will improve market efficiency by reducing the amount of fraudulent phoenix activity.

Analysis of costs

Business

1.231 The director penalty regime already applies to all directors where their company has failed to pay its PAYG withholding to the Commissioner. The extension of the director penalty regime to the superannuation guarantee charge and the imposition of the PAYG withholding non-compliance tax will increase the potential personal liability of directors for their company's failure to meet its obligations. However, the legislation provides the Commissioner with some flexibility about how to target the amendments to the highest risk and most egregious cases, such as fraudulent phoenix companies.

1.232 The changes will reduce the benefits associated with fraudulent phoenix activity, as they will reduce the ability of fraudulent phoenix companies to use their employees' PAYG withholding and

superannuation guarantee as part of their cash flow and to accumulate large debts.

1.233 These factors will reduce their ability to undercut legitimate business operators in the market place and will make it easier for creditors (including the ATO and employees) to identify fraudulent phoenix activity, potentially exposing the participants in phoenix activity to additional penalties and trading difficulties. These factors are designed to make fraudulent phoenix activity less attractive overall.

1.234 These amendments are not expected to increase compliance or operating costs for businesses or directors of companies who are complying with their existing obligations. The amendments do not introduce any new obligations on companies but they do increase disincentives for directors (and their associates) to allow companies to engage in fraudulent phoenix activity.

1.235 There is a small risk that the amendments may reduce entrepreneurial activity because of the changes to a director's potential personal liability. However, the fact that directors are already subject to potential penalties for the same conduct, and the targeting of the changes, will reduce the risk to honest and competent entrepreneurs.

1.236 The inability of the Commissioner to commence proceedings to recover the PAYG withholding non-compliance tax whilst a director has a director penalty liability reduces the possibility that directors will be impacted twice for the company's same PAYG withholding non-compliance debt.

Employees

1.237 These amendments potentially impact directors that are receiving payments from their company such as director's fees. They also potentially impact associates of directors who are employed by the company through the imposition of the PAYG withholding non-compliance tax where certain criteria are met.

1.238 These proposals are not expected to lead to increased costs or increased compliance burdens for other employees.

ATO

1.239 The ATO may engage in activities to raise awareness about the new laws, through changes to the ATO websites and publications, and by contacting tax agents and insolvency specialists, particularly through consultative forums and seminars.

1.240 According to the 2011-12 Budget, the amendments have a related increase in ATO departmental expenses of $22.1 million over the forward estimates period.

Creditors

1.241 The proposals may encourage companies to pay their tax and superannuation obligations ahead of debts to other creditors and once the company goes into liquidation there is less money and assets available for distribution to these other creditors.

Community

1.242 These proposals are not expected to lead to increased costs or increased compliance burdens for the community in general.

Conclusions

1.243 Although it is difficult to quantify the benefits and costs of these proposals, it is considered that on balance the proposals will provide a net benefit. The benefits will be based around improved tax compliance by companies and reduced incentives for companies to undertake fraudulent phoenix activity. Improved compliance will provide benefits for employees, with regard to access to superannuation guarantee amounts and the community through improved collection of tax debts. The costs, for the most part, are for companies who would be actively seeking to avoid their tax and superannuation obligations to gain an unfair competitive advantage. The measures are expected to even the playing field for companies that comply with their tax and superannuation obligations; these companies are not expected to bear any additional costs from these proposals.

Consultation statement

1.244 A range of options were set out for public consultation in the *Action Against Fraudulent Phoenix* proposals paper. The proposals that formed this election commitment were included in that proposals paper. The paper was open to submissions from the public from 14 November 2009 to 15 January 2010.

1.245 Consultation on draft legislation was undertaken from 5 July 2011 to 1 August 2011. The majority of the submissions related to the policy underlying the changes, not to the technical nature of the legislative amendments.

1.246 Twenty-eight submissions were received in response to the proposals paper. The views set out in the public submissions in relation to the three proposals are set out below.

Automating the director penalty regime

1.247 Fifteen submissions commented expressly on automation.

- Six submission supported automation after three months on the basis that it will reduce the incentive to engage in fraudulent phoenix activity and it will ease the administrative burden on the ATO, allowing the ATO to respond more effectively to a problem that is already unlawful and appears to be extensive.
- Two submissions supported automation after a period of six months on the basis that PAYG withholding reflects amounts that are held on trust.
- The Commonwealth Ombudsman's submission gave general support for the automation of the director penalty regime, but suggested that there should be a review mechanism to allow the ATO to release a director from liability and suggested that notices setting out the outstanding liability should be sent to directors.
  - Several defences will be available to directors, including where the director was not involved in the management of the company, took all reasonable steps to achieve compliance or no such steps were available (section 269-35 in Schedule 1 to the TAA 1953). In addition, the Commissioner has a general power to decide whether to enforce a tax debt.
- Another two submissions, while not rejecting the proposal, expressed concern that the proposal was not sufficiently targeted at fraudulent phoenix activity and that the automatic period should be long enough to allow for seasonal fluctuations in cash flow and give directors time to become familiar with the business's financial situation.
  - The current proposal has been targeted at fraudulent phoenix activity by limiting it to companies that do not report their outstanding liabilities. As a result, most honest and competent directors will not be impacted by the change.

- PAYG withholding amounts that have been withheld should be held on trust and therefore should not be included in business cash flow.

- Directors will have a right of indemnity against the company (section 269-45 in Schedule 1 to the TAA 1953). Directors will also be able to access defences, such as where the director was not involved in the management of the company or took all reasonable steps to achieve compliance (section 269-35 in Schedule 1 to the TAA 1953).

1.248 Four submissions did not support automating the director penalty regime. Three of these submissions were made by committees of the Law Council's Business Law Section (the Corporations Law Committee, the Reconstruction Law Committee and the Taxation Law Committee) and one was made by the law firm Pitcher and Partners. They were concerned that:

- automation effectively reinstates the ATO's priority in company liquidations because companies will pay tax debts before private debts;

- automation is unnecessary — the ATO should utilise its existing powers more effectively; and

- the proposal should be more targeted.

1.249 Following recommendations from the House of Representatives Standing Committee on Economics, and subsequent further consultation with industry, the Government decided not to proceed with automation. Instead, in all cases the Commissioner will issue a director penalty notice before commencing recovery proceedings. However, the remission options available to directors for amounts unpaid and unreported after three months will still be limited such that directors will not be able to avoid personal liability for director penalties after three months by placing their company into administration or beginning to wind it up.

Extending the director penalty regime to superannuation guarantee

1.250 Fourteen submissions commented on the proposal to extend the director penalty regime to superannuation guarantee liabilities.

- Nine out of 14 submissions supported extending the director penalty regime beyond PAYG withholding.

- All of those nine submissions supported extending the director penalty regime to a range of taxes, such as company income tax and GST, not just superannuation guarantee liabilities.

- Three submissions supported extending the director penalty regime beyond tax liabilities to include other worker entitlements.

- These submissions noted that extending the director penalty regime would discourage fraudulent phoenix activity and remove distortions in the tax system (where one type of tax is paid in preference to another).

- These submissions considered that other creditors would not be prejudiced and that honest directors would have nothing to fear.

- The submissions noted the importance of superannuation guarantee liabilities to retirement incomes and their relationship with other entitlements, such as insurance and workers compensation.

- The Commonwealth Ombudsman noted that ten per cent of complaints it received about taxation administration were about the ATO's inability to recover superannuation guarantee liabilities.

- Overall, they considered that extending the director penalty regime to superannuation guarantee liabilities was justified on public interest grounds.

• The Institute of Chartered Accountants stated that they do not support extending the director penalty regime beyond PAYG withholding on the basis that attaching personal liability to directors is only appropriate for PAYG withholding because it represents amounts that are essentially held on trust.

  - Although superannuation guarantee is not held on trust per se, it does represent an amount that the company is obliged to pay for the benefit of the employee. Employees receive the benefit of PAYG withholding credits regardless of whether the amount is recovered from the employer. In contrast, employees do not receive superannuation guarantee amounts that are not recovered from the employer.

- Pitcher Partners did not object to the extension of the director penalty regime but did not believe that it would help to curb fraudulent phoenix activity.
  - There is evidence to suggest that fraudulent phoenix operators often use their employees' superannuation guarantee entitlements as part of the businesses cash flow to generate profits for themselves and to prolong the life of the phoenix company. Making directors potentially liable for such amounts will discourage this behaviour.
- The Australian Institute of Company Directors and the three committees of the Business Law Section of the Law Council of Australia opposed the expansion of the director penalty regime on the basis that it would effectively make the Crown a priority creditor.
  - Providing an incentive to pay a particular debt will encourage that debt to be paid in preference to other debts, in the same way that the other debts might be preferred in the absence of that debt. Unlike other creditors, the ATO cannot protect itself by refusing to provide credit.
- The Taxation Law Committee of the Business Law Section of the Law Council of Australia suggested that it is not always clear whether a person is an employee (and, therefore it may not be clear that there is a superannuation guarantee liability).
  - The term 'employee' for superannuation guarantee purposes is defined under section 12 of the SGA Act 1992 to include common law employees and an expanded definition of employees including individuals working under a contract wholly or principally for labour, members of the board of directors or executive body of a company and artists, musicians and sportspersons who are paid to perform or present.
  - Whether a person is an employee or an independent contractor for the purposes of the superannuation guarantee is a question of fact to be determined by examining the terms and circumstances of the arrangement between the payer and the person performing the work. The ATO superannuation guarantee ruling SGR 2005/1 provides guidance on how to determine whether an individual is an employee. The ATO also has

an online decision tool to assist businesses to determine whether a worker is engaged under an employment relationship.

- In the circumstances where the company or director was not aware, and could not reasonably have known, that a person was an employee, then the director would be able to utilise the defence that they took all reasonable steps to comply or that no such steps were available (subsection 269-35(3) in Schedule 1 to the TAA 1953).

- Directors will also have a right of indemnity against the company (section 269-45 of Schedule 1 to the TAA 1953).

• The Corporations Committee of the Business Law Section of the Law Council of Australia commented that extending the director penalty regime to superannuation guarantee liabilities would exacerbate the existing administrative problems with the director penalty regime.

- Most fraudulent phoenix operators avoid paying more than one type of tax. As such, certain efficiencies would be achieved by expanding the director penalty regime. For example, after contacting ASIC to identify the directors of a company, the ATO could issue director penalty notices in relation to more than one tax liability without contacting ASIC again.

- The administrative problems associated with the director penalty regime will be eased through the automation of the regime as set out in this proposal.

Denying PAYG withholding credits to directors and their associates

1.251 Nine submissions commented on the proposal to deny PAYG withholding credits to directors and their associates for unpaid PAYG withholding.

• Five submissions supported the proposal on the basis that it would discourage fraudulent phoenix activity.

- The submissions generally supported denying PAYG withholding credits to directors and their families on the basis that this would provide an additional incentive not to engage in fraudulent phoenix activity.

  - Barrett Walker suggested that denying credits to other employees who knew of, or were involved in, the non-payment of PAYG withholding would encourage reporting of fraudulent phoenix behaviour.

- Pitcher and Partners submitted that the proposal had merit but would not directly address fraudulent phoenix activity.

  - There is evidence that fraudulent phoenix company operators routinely fail to pay PAYG withholding to the Commissioner and then benefit from the non-payment by claiming those credits.

- Three submissions did not support the proposal.

  - The Housing Industry Association rejected the proposal on the basis that an error on the part of the ATO would adversely affect taxpayers. However, it was not clear why the Housing Industry Association considered this a bigger risk than the ATO making errors generally.

  - The Taxation Committee of the Law Council of Australia considered that denying such credits would require allocating unpaid PAYG withholding amounts between directors and employees and that the benefit achieved would not be worth the effort required.

  - The election costing of this proposal suggests that there will be a positive gain to the revenue from these proposals even after an allowance has been made for the administrative costs of the ATO.

Conclusion and recommended option

1.252 This proposal is an election commitment so there is no *recommended option* for the purpose of the regulation impact statement.

Chapter 2
Amendments to the TOFA consolidation interaction and transitional provisions

Outline of chapter

2.1 Schedule 2 to this Bill amends section 715-375 of the *Income Tax Assessment Act 1997* (ITAA 1997) to ensure that, for consolidated groups applying Division 230 of the ITAA 1997 in relation to their financial arrangements, the head company is deemed to have received an amount for assuming an accounting liability that is, or is part of, a financial arrangement as part of a joining/consolidation event. This amount is deemed to be the accounting liability's accounting value at the joining time.

2.2 This Schedule also amends the transitional provisions in the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* (TOFA Act) to ensure that:

- section 715-375 and subsection 701-55(5A) of the ITAA 1997 (TOFA consolidation interaction provisions) apply to a joining/consolidation event that occurred prior to the consolidated group starting to apply the TOFA provisions in relation to its financial arrangements (pre-TOFA joining) if the head company has made a transitional election to apply the TOFA provisions to its existing financial arrangements;

- the method for working out transitional balancing adjustments that uses tax deferred amounts from the head company's financial reports cannot be used to transition existing financial arrangements, acquired/assumed as part of a pre-TOFA joining, into the TOFA regime; and

- for assets acquired as part of a pre-TOFA joining and if the head company has made a transitional election, the difference between the tax cost setting amount and the starting value for TOFA purposes is spread over four years from the head company's first income year in which it applies the TOFA provisions in relation to its financial arrangements (first TOFA year).

2.3 All references to legislative provisions in this chapter are references to the ITAA 1997 unless otherwise stated.

2.4 In this chapter, an asset refers to an asset that is, or is part of, a financial arrangement, and a liability refers to a liability that is, or is part of, a financial arrangement.

Context of amendments

2.5 The TOFA Act commenced on 26 March 2009. It inserted Division 230, related consequential provisions (including the TOFA consolidation interaction provisions, sections 701-55(5A) and 715-375) and the TOFA transitional provisions into income tax law (the TOFA provisions). The TOFA provisions represent a major legislative reform to the tax law applying to a complex area of commerce.

2.6 The TOFA provisions define what a Division 230 financial arrangement is and provide various tax timing methods to account for the gains and losses from holding and ceasing to hold the financial arrangement for income tax purposes.

2.7 The TOFA provisions generally apply to financial arrangements that a TOFA taxpayer starts to have during income years commencing on or after 1 July 2010, unless the taxpayer has elected to have the TOFA provisions apply for income years commencing on or after 1 July 2009. A TOFA taxpayer is a taxpayer that applies the TOFA provisions in relation to its financial arrangements.

2.8 Shortly after their introduction, the Government announced that technical amendments and further integrity measures may be necessary to ensure the law operates as intended (see the then Assistant Treasurer's Media Releases No. 103 of 4 December 2008 and No. 22 of 26 March 2009). Several tranches of amendments to the TOFA provisions were announced and/or made following the Government's monitoring of the implementation of the reform, including the then Assistant Treasurers' Media Releases No. 043 of 4 September 2009, No. 005 of 12 January 2010, No. 145 of 29 June 2010 and No. 019 of 29 November 2010. All applied with retrospective effect from the commencement of the TOFA provisions.

2.9 The TOFA consolidation interaction provisions are intended to ensure appropriate interaction between the TOFA regime and the consolidation regime. The provisions specify, for TOFA purposes, the tax treatment of financial arrangements that are part of a joining/consolidation event where the head company is a TOFA taxpayer.

2.10 The TOFA transitional provisions allow a TOFA taxpayer to elect to apply the TOFA provisions to its existing financial arrangements (that is, those that it started to have before the taxpayer's first TOFA year). These provisions are designed to reduce TOFA taxpayers' compliance costs by allowing the taxpayer to apply one set of tax provisions to all of their financial arrangements.

2.11 If such an election is made, the taxpayer is required to make transitional balancing adjustments for their existing financial arrangements. There are two methods of working out the TOFA transitional balancing adjustments for existing financial arrangements — a primary and alternative method.

2.12 The primary method, found in subitem 104(13) of Schedule 1 to the TOFA Act, involves comparing, for an existing financial arrangement, the amounts that have already been subject to tax, with the amounts that would have been subject to tax had the taxpayer applied the TOFA provisions from the time the TOFA taxpayer started to have the financial arrangement.

2.13 The alternative method, found in subitems 104(14) and (15) of Schedule 1 to the TOFA Act, uses the balances of the deferred tax asset and deferred tax liability accounts in the head company's financial reports. These balances usually approximate the outcome worked out under the primary method.

2.14 If the transitional balancing adjustment is positive, a quarter of this amount will be included in the taxpayer's assessable income for the first income year that Division 230 applies and each of the next three income years. Conversely, if the transitional balancing adjustment is negative, a quarter of this amount may be allowed as a deduction for the first income year that Division 230 applies and each of the next three income years.

2.15 Post-enactment consultation with industry and the Australian Taxation Office (ATO) on the TOFA provisions revealed several technical deficiencies with the current wording of the TOFA consolidation interaction provisions and how they interact with the TOFA transitional provisions.

2.16 On 25 November 2011, the then Assistant Treasurer, announced in Attachment B to Media Release No. 159 of 2011, changes to the TOFA consolidation interaction provisions and the TOFA transitional provisions to address the deficiencies identified.

Summary of new law

Amendments to TOFA consolidation interaction provisions

2.17 For liabilities that are to be subject to the fair value, reliance on financial reports or retranslation tax timing method, the amendments clarify that the head company of a consolidated group is deemed to have received an amount for assuming the liability at the joining time. The deemed amount is the liability's accounting value at the joining time.

2.18 For liabilities that are to be subject to a tax timing method other than the fair value, financial reports or retranslation method, the amendments deem the head company of a consolidated group to have received an amount for assuming the liability at the joining time. The deemed amount is the liability's accounting value at the joining time applying the joining entity's accounting principles.

Amendments to TOFA transitional provisions

2.19 The amendments to the TOFA transitional provisions ensure that the TOFA consolidation interaction provisions apply when transitioning existing financial arrangements acquired or assumed by the head company of a consolidated group as part of a pre-TOFA joining, where the head company has made a TOFA transitional election.

2.20 In particular, subject to the carve outs and adjustments as outlined below, the amendments:

- clarify that the TOFA transitional balancing adjustments and TOFA balancing adjustments take into account the operation of the TOFA consolidation interaction provisions;
- ensure that the head company of a consolidated group can only use the primary method in working out the transitional balancing adjustments for financial arrangements that the head company acquired as part of a pre-TOFA joining; and
- ensure that, for assets acquired as part of a pre-TOFA joining where the head company has made the transitional election and applies the fair value, reliance on financial reports or retranslation tax timing method, the difference between the tax cost setting amount and the head company's starting value for TOFA purposes is generally spread over four years from the head company's first TOFA year.

Carve outs and adjustments regarding pre-TOFA joining

2.21 Assets and liabilities of a chosen transitional entity (within the meaning of Division 701 of the *Income Tax (Transitional Provisions) Act 1997*) that are acquired as part of a pre-TOFA joining are excluded from the application of the amendments to the TOFA transitional provisions.

2.22 For transitional purposes, the amount that the head company is deemed to have received for assuming liabilities that are part of a pre-TOFA tax consolidation of a wholly owned group (pre-TOFA formation) is the joining entity's tax carrying value for the liability just before the joining time (that is, the value which would result in no assessable income or allowable deduction if the joining entity were to cease to have the liability at that time).

Commencement and application

2.23 The amendments commence on 26 March 2009 (that is, the commencement of the TOFA provisions). The TOFA consolidation interaction amendments apply from a taxpayer's first TOFA year. The amendments to the TOFA transitional provisions apply from their commencement.

2.24 Regarding a pre-TOFA joining, assets that are subject to certain prior private ruling or written advice that the Commissioner of Taxation (Commissioner) has issued, and liabilities that are the same kind of financial arrangement as those assets, are carved out from the application of the amendments under certain circumstances.

Comparison of key features of new law and current law

New law	*Current law*
The head company of a consolidated group is deemed to have received an amount for the assumption of the joining entity's liabilities at the joining time.	The head company of a consolidated group is treated as starting to have the joining entity's liabilities at the joining time.
For liabilities that are subject to a tax timing method other than the fair value, reliance on financial reports or retranslation tax timing method, the head company is deemed to have received an amount equal to the	For liabilities that are subject to a tax timing method other than the fair value, reliance on financial reports or retranslation tax timing method, the entry history rule applies to determine the value of liabilities that the head

New law	Current law
amount of the liability as determined in accordance with the joining entity’s accounting principles for tax cost setting or comparable standards for accounting made under a foreign law at the joining time.	company is treated as starting to have at the joining time.
The TOFA transitional balancing adjustments and balancing adjustments are generally worked out as if the TOFA consolidation interaction provisions had applied to financial arrangements that the head company assumes as part of a pre-TOFA joining.	It is unclear whether the TOFA consolidation interaction provisions apply to financial arrangements that the head company assumes as part of a pre-TOFA joining and makes a TOFA transitional election to bring into the TOFA regime.
The head company that has made a transitional election to bring their existing financial arrangements into the TOFA regime, can generally only use the primary method when working out their TOFA transitional balancing adjustments for financial arrangements it assumed as part of a pre-TOFA joining.	In certain circumstances, the head company that has made a TOFA transitional election to bring their existing financial arrangements into the TOFA regime and the reliance on financial report tax timing election, must use the alternative method to work out its TOFA transitional balancing adjustments for financial arrangements it assumed as part of a pre-TOFA joining.
For assets acquired as part of a pre-TOFA joining where the head company has made the transitional election and applies the fair value, reliance on financial reports or retranslation tax timing method, the difference between the tax cost setting amount and the head company’s starting value for TOFA purposes is generally spread over four years from the head company’s first TOFA year.	It is unclear whether section 701-61 applies to assets acquired as part of a pre-TOFA joining where the head company has made the transitional election.

Detailed explanation of new law

Amendments to TOFA consolidation interaction provisions

Clarification that the liability is one to which the head company would apply the TOFA provisions just after joining

2.25 Schedule 2 of the Bill amends paragraph 715-375(1)(c) so that, in order for subsection 715-375(2) to apply, the liability assumed by the head company at the joining time must be, or be part of, a Division 230 financial arrangement of the head company at the joining time — the joining entity's TOFA status being irrelevant. ***[Schedule 2, item 2, paragraph 715-375(1)(c)]***

2.26 By disregarding the single entity rule under subsection 701-1(1) of the ITAA 1997, item 1 of Schedule 2 to this Bill clarifies that the determination of whether there is a liability must be done from the joining entity's perspective at the joining time. ***[Schedule 2, item 1, paragraph 715-375(1)(b)]***

2.27 Currently, subsection 715-375(1) sets out the pre-conditions for subsection 715-375(2) to apply. Paragraphs 715-375(1)(a) and (b) make clear that the subject of section 715-375 is the accounting liability of the joining entity at the joining time (which in this context means immediately before the joining time).

2.28 Paragraph 715-375(1)(c) requires a joining entity's accounting liability to be a 'Division 230 financial arrangement' (or be a part of one). Subsection 995-1(1) defines a *Division 230 financial arrangement* to be a financial arrangement to which Division 230 applies in relation to the taxpayer's gains and losses from the arrangement.

2.29 Where the joining entity is not a TOFA entity (that is, an entity not applying Division 230 to its financial arrangement liabilities) immediately before the joining time, paragraph 715-375(1)(c) is not satisfied if applied from the joining entity's perspective. Consequently, subsection 715-375(2) would not apply to deem the head company as having assumed the liabilities at the joining time. This is unintended.

2.30 The amendments clarify that, while paragraphs 715-375(1)(a) and (b) apply from the joining entity's perspective, paragraph 715-375(1)(c) operates from the head company's perspective.

2.31 The current paragraph 715-375(1)(c) also pose a circularity issue with respect of the application of sections 715-375(2) to (4) to a pre-TOFA joining. This issue is addressed in the amendments to the TOFA transitional provisions (see paragraph 2.67).

Deeming the head company to have received a payment for starting to have a liability at the joining time

2.32 Schedule 2 of the Bill repeals subsections 715-375(2), (3) and (4), replacing them with a new subsection 715-375(2). This new subsection deems the head company to have received a payment for starting to have the joining entity's liabilities at the joining time. ***[Schedule 2, item 3, subsection 715-375(2)]***

Liabilities subject to the fair value, reliance on financial reports or retranslation tax timing method — the amount of the deemed payment received

2.33 For liabilities subject to the fair value, reliance on financial reports or retranslation tax timing method, the deemed payment received equals the amount of the liability assumed by the head company as determined under the current subsections 715-375(3) and (4), that is, the 'Division 230 starting value' as defined in subsection 995-1(1) ***[Schedule 2, item 3, paragraph 715-375(2)(b)]***. This value is the amount of the liability according to the relevant accounting standard referred to under each of the tax timing methods respectively, that apply in relation to the arrangement.

2.34 For liabilities subject to the fair value, reliance on financial reports or retranslation tax timing method, the amendments ensure that the law operates to achieve the original policy intent as outlined in paragraph 12.44 of the explanatory memorandum to the Tax Laws Amendment (Taxation Of Financial Arrangements) Bill 2009 (TOFA explanatory memorandum) that became the TOFA Act:

> 'for liabilities that are or form part of financial arrangements that are subject to the fair value, foreign exchange retranslation, or reliance on financial reports method, the head company applies Division 230 as if the liability were assumed at the time of joining for an amount equal to the liability's Division 230 starting value.'

2.35 If the head company is not deemed to have received a payment equal to the liability's Division 230 starting value at the joining time, and treats the amount of the liability as being its Division 230 starting value at the joining time for the purposes of applying any of the TOFA tax timing methods and Subdivision 230-G balancing adjustments, the head company would be able to obtain tax outcomes for gains or losses that accrued during the period prior to the joining time, in which the joining entity held the accounting liability.

2.36 Such an approach is inconsistent with the TOFA overarching objective to allocate the gains and losses from a financial arrangement to

'the period to which the gains or losses relate' so as to more closely align with commercial norms.

Example 2.1: Derivative liability assumed by the head company as part of a consolidation event and to which the fair value, reliance on financial reports or retranslation tax timing method applies

On 1 July 2011, a joining entity enters into a cash-settlable forward transaction for $0. The term of the forward is three years.

On 1 July 2012, the joining entity becomes a subsidiary member of a consolidated group, which is a TOFA taxpayer (having entered the TOFA regime on 1 July 2010) and who has made a fair value tax timing election.

At the time of joining, the forward has a fair value of –$120. Because the forward is fair valued through profit/loss for accounting purposes, –$120 is also the amount for tax purposes under the fair value tax timing method.

On 1 July 2014, the forward matures with a fair value of –$100, and is settled with a payment of $100.

As subsection 715-375(1) is satisfied, the amended paragraph 715-375(2)(b) applies to treat the head company of the consolidated group as starting to have the forward at the joining time for receiving a payment equal to $120, the forward's Division 230 starting value at the joining time.

On disposal the head company brings to account no gain or loss for tax purposes, as the $20 gain (being the difference between the deemed receipt of $120 and actual payment of $100 to settle the forward) has already been required to be brought to account under the fair value tax timing method (being the change in fair value of the forward from the time the head company assumes the forward from the joining entity until the swap matures).

Without the amendments to subsection 715-375(2), the head company would be treated as starting to have an accounting liability at joining time, valued at –$120 (its Division 230 starting value at the joining time) for the purposes of Division 230.

At disposal, without the amendments, the head company would be able to deduct $120 loss, as the head company paid $100 to settle the forward (which would not be offset by the deemed receipt) and brought to account $20 gain under the fair value tax timing method.

Liabilities subject to the accruals/realisation tax timing methods or tax hedging method — the amount of the deemed payment received

2.37 The amended subsection 715-375(2) sets the amount of the deemed payment received for the liability and the amount of the liability in the hands of the head company to be the accounting value of the liability applying the joining entity's accounting principles. ***[Schedule 2, item 3, paragraph 715-375(2)(a)]***

2.38 For liabilities subject to the accruals/realisation tax timing methods or tax hedging method, the current subsection 715-375(2) does not specify the amount of the liability in the hands of the head company at the joining time.

2.39 Paragraph 12.43 of the TOFA explanatory memorandum states that the consolidation entry history rule applies to these liabilities. In practice, this means that the head company assumes the liability for its original value (taking into account any repayments of the principal prior to the joining time).

2.40 Setting the amount of the liability in the hands of the head company at the joining time as its original value (applying the entry history rule) does not recognise the fact that, like assets, the value of the liability can change for reasons other than repayments of the principal, for example, foreign currency denominated loans.

2.41 To take into account the changes in the value of these liabilities, the amendments set the amount of the liability in the hands of the head company as the accounting value of the liability.

2.42 However, unlike the fair value, reliance on financial reports or retranslation tax timing method, there are no specific accounting standards that apply to determine the tax treatment of financial arrangements that are subject to the accruals/realisation tax timing methods.

2.43 Moreover, there is a possibility that the accounting principles applied to the liability by the joining entity immediately before the joining time are not the same accounting principles that the head company applies to its liabilities. This could result in there being two different accounting values for the liability at the joining time. Using the head company's accounting principles may result in the difference not being subject to taxation.

2.44 To address these issues, paragraph 715-375(2)(a) sets the amount of the liability subject to the accruals/realisation tax timing methods or the tax hedging method in the hands of the head company at the joining time to be the amount of the liability, as determined in

accordance with the joining entity's accounting principles for tax cost setting or comparable standards for accounting made under a foreign law. ***[Schedule 2, item 3, paragraph 715-375(2)(a)]***

Example 2.2: Foreign currency denominated loan assumed by the head company as part of a consolidation event and to which the accruals/realisation tax timing methods applies

On 1 July 2011, a joining entity enters into a foreign currency denominated liability under which:

- it receives US$100 on 1 July 2011,
- must pay AU$10 interest on 1 July 2012, 1 July 2013 and 1 July 2014; and
- must repay US$100 on 1 July 2014.

As at 1 July 2011, AU$1 buys US$1. As a result, the AUD value of the US$100 received is $100.

On 1 July 2012, just after the interest payable on 1 July 2012 is paid, the joining entity becomes a subsidiary member of a consolidated group, which is a TOFA taxpayer (having entered the TOFA regime on 1 July 2010). The head company makes no TOFA tax timing method election, and as a result applies the accruals/realisation tax timing methods to its financial arrangements (including the liability).

At the time of joining, the joining entity's accounting principles for tax cost setting determine the amount of the liability as –$120. This is because, at the time of joining, AU$1 buys US$0.8333.

On 1 July 2014, US$100 is repaid. The AUD value of this payment, at the time of payment, is $120.

As subsection 715-375(1) is satisfied, the new paragraph 715-375(2)(a) applies to treat the head company of the consolidated group as starting to have the accounting liability at the joining time for receiving a payment equal to $120. This is the amount of the liability determined in accordance with the joining entity's accounting principles for tax cost setting at the joining time.

The amount of the liability in the hands of the head company at the joining time (that is, –$120) is used to work out the gain or loss and the spreading of that gain or loss on an on-going basis.

On 1 July 2014, the liability comes to an end. For the purposes of working out the Subdivision 230-G balancing adjustment for the liability, the head company is deemed to have received $120 for assuming the liability under step 1(a) of the method statement.

Deeming the head company to have had an obligation to provide for an asset, or a right to receive for a liability, the deemed payment

2.45 Where section 701-55(5A) and the new section 715-375(2) deems the head company as having provided or received a payment for starting to have an asset or liability at the joining time respectively, for the purposes of applying section 230-60, the amendments deem the head company to have had an obligation to provide or right to receive that payment. ***[Schedule 2, item 4, section 715-378]***

2.46 This is to ensure that, for Division 230 purposes, the payment is taken into account in working out the gain or loss from the asset or liability that the head company assumes as part of a joining/consolidation event.

2.47 Section 230-60 deems a right to receive or an obligation to provide a financial benefit in relation to a financial arrangement to be a right or obligation under the financial arrangement, if the financial benefit plays an integral role in determining whether there is a gain or loss from the arrangement or the amount of such gain or loss.

2.48 In circumstances where the application of section 230-60 is required to take into account the deemed payment in working out the gain or loss from the asset or liability, the head company would need to have had an obligation to provide or a right to receive that deemed payment ‘under the financial arrangement’ as opposed to ‘for the financial arrangement’.

Amendments to TOFA transitional provisions

2.49 Item 5 of Schedule 2 to the Bill amends the TOFA transitional provisions so that:

- the TOFA consolidation interaction provisions apply to joining entities other than chosen transitional entities when applying the TOFA transitional balancing or other TOFA provisions in relation to assets and liabilities that are part of a pre-TOFA joining;
- the head company cannot use the alternative method to work out the TOFA transitional balancing adjustments for these assets and liabilities;
- for assets that are part of a pre-TOFA joining being transitioned into the TOFA regime, the difference between the asset’s tax cost setting amount and its Division 230

starting value is to be spread over four years from the head company's first TOFA year; and

- for liabilities that are part of a pre-TOFA formation, the amount of the deemed payment is an amount which would result in there being no tax consequences for the joining entity if it were to cease to have the liability just before the joining time (tax carrying value).

[Schedule 2, item 5, subitem 104B]

Conditions for the application of TOFA transitional amendments

2.50 Subitem 104B(1) provides the conditions for the application of the amendments to the TOFA transitional provisions. ***[Schedule 2, item 5, subitem 104B(1)]***

2.51 The amendments only apply to assets and liabilities that the head company acquires/assumes from the joining entity at the joining time as a result of the single entity rule ***[Schedule 2, item 5, paragraphs 104B(1)(a) and (b)].*** The single entity rule states that following consolidation, members of a consolidated group are treated as a single entity for income tax purposes. Subsidiary entities lose their individual income tax identities and upon entry into a consolidated group are treated as part of the head company.

2.52 These assets and liabilities must be, or must be part of, a financial arrangement at the start of the head company's first applicable income year. ***[Schedule 2, item 5, paragraph 104B(1)(c)]***

2.53 Item 102 of Schedule 1 to the TOFA Act defines first applicable income year. It is the first income year for which the TOFA provisions apply to the taxpayer.

2.54 Subsection 995-1(1) defines a 'financial arrangement' as having the meaning given by sections 230-45 to 230-50. That is, the asset or liability is, or is part of, a financial arrangement that satisfies either section 230-45 or 230-50.

2.55 The head company's first TOFA year must start after the joining time and the head company must have the asset or liability for the whole period from the joining time to the start of the head company's first TOFA year, whether or not because of the single entity rule. ***[Schedule 2, item 5, paragraphs 104B(1)(d) and (e)]***

2.56 'Joining time' is identified in the new paragraph 104B(1)(a) as the time the joining entity becomes a subsidiary member of the consolidated group or MEC group.

2.57 The intention of the inclusion of the words 'whether or not because of … the single entity rule…' is to ensure that item 104B applies where the head company acquires/assumes financial arrangements from the joining entity at the joining time pursuant to a joining/consolidation event, and later the joining entity legally transfers those financial arrangements to the head company.

2.58 The head company must elect to have subitem 104(2) apply to itself. ***[Schedule 2, item 5, paragraph 104B(1)(f)]***

2.59 The joining entity must not be a chosen transitional entity within the meaning of Division 701 of the *Income Tax (Transitional Provisions) Act 1997*. ***[Schedule 2, item 5, paragraph 104B(1)(g)]***

2.60 Prior to the end of 2005, head companies could choose to make a joining entity, a chosen transitional entity. Generally, the effect of such a choice meant that the tax cost setting amount of the assets of such entities was not worked out at the joining time. To be consistent with this choice, the assets (or liabilities) of these entities are carved out from the application of these amendments.

Assets that are part of a pre-TOFA joining

2.61 Paragraph 104B(2)(a) ensures that the TOFA consolidation interaction provisions apply for the purposes of working out the TOFA transitional adjustments and applying the TOFA provisions generally in relation to assets that are part of a pre-TOFA joining. ***[Schedule 2, item 5, subitem 104B(2)(a)]***

2.62 Subsection 701-55(5A) provides that, for TOFA purposes, the head company is deemed to have acquired the asset for its Division 230 starting value (where the asset is subject to a fair value, reliance on financial reports or retranslation tax timing election), or its tax cost setting amount (where the asset is subject to the accruals/realisation tax timing methods or tax hedging method) at the joining time.

2.63 However, it is unclear whether subsection 701-55(5A) can apply to assets that are part of a pre-TOFA joining for the purposes of working the TOFA transitional balancing adjustment for the asset and applying the TOFA provisions to the asset after transitioning the asset into the TOFA regime. This is because the pre-condition for the subsection to apply is 'if Division 230 is to apply in relation to the asset' at the joining time.

2.64 The assumed application of subsection 701-55(5A) to a pre-TOFA joining has the following implications:

- for the purposes of working out the TOFA transitional balancing adjustment for the asset:
  - the head company is deemed to start to have the asset at the joining time, which is prior to the head company entering into the TOFA regime (that is, for steps 1 to 4 of subitem 104(13) of the TOFA Act); and
  - the amount subsection 701-55(5A) deems the head company to have provided for acquiring the asset sets the amount of the asset in the hands of the head company at the joining time which is then taken into account in working out what would be the tax outcome if the TOFA provisions had applied to the asset from the time the head company starts to have the asset (that is, steps 1 and 2 of subitem 104(13) of the TOFA Act. Steps 3 and 4 of subitem 104(13) of the TOFA Act are not intended to be affected); and
- the head company's deemed payment for the asset at the joining time is taken into account in working out the gain or loss from the asset under the TOFA provisions including the Subdivision 230-G balancing adjustment that is made when the asset ceases to be held by the head company (for example, upon maturity or disposal).

Example 2.3: Derivative asset that the head company acquires as part of a pre-TOFA joining and transitions into the TOFA regime

On 1 July 2008, a joining entity enters into a cash-settlable forward transaction for $0. The term of the forward is four years.

On 1 July 2009, the joining entity becomes a subsidiary member of a consolidated group. At the time of joining, the forward has a fair value of $120. As the forward is fair valued through profit/loss for accounting purposes, $120 is also the amount of the asset for tax purposes applying the fair value tax timing method.

The head company continues to hold the forward until it enters into the TOFA regime on 1 July 2010, which is the start of the head company's first TOFA year. At that time, the fair value of the asset is $100.

On 1 July 2010, the head company makes an irrevocable election under item 104(2) of the TOFA Act to apply the TOFA provisions in relation to all of the financial arrangements it had on 1 July 2010. It also makes a valid fair value tax timing election under Subdivision 230-C.

As such, the asset satisfies the conditions under the subitem 104B(1). Paragraph 104B(2)(a) applies in relation to the asset. The assumed application of subsection 701-55(5A) to the asset has the following consequences:

- for the purposes of applying subitem 104(13) of the TOFA Act in working out the transitional balancing adjustment for the asset, the head company is treated as if it acquired the asset at the joining time for a payment equal to the asset's Division 230 starting value at the joining time; and
- for the purposes of applying Division 230, for example, in working out the Subdivision 230-G balancing adjustment for the forward when it matures on 1 July 2012, the head company is deemed to have paid an amount equal to the forward's Division 230 starting value at the joining time.

Transitional balancing adjustment

Applying this assumption, the result of the transitional balancing adjustment would be as follows:

Step 1: $0 (This is because the subitem 104(13) method statement is calculated on the assumption that subsection 701-55(5A) applied in relation to the asset at the joining time that resulted in the head company starting to have the asset. As such, the increase in fair value of the forward that occurred between 1 July 2008 and 1 July 2009 is ignored for the purposes of step 1).

Step 2: $20 (The decrease in the fair value from the joining time would have been a loss that would have been made from the forward, had Subdivision 230-C applied in relation to the forward after the joining time).

Step 3: $0 (No amounts have been assessed since the joining time).

Step 4: $0 (No amounts have been deducted since the joining time).

Step 5: $0

Step 6: $20

Step 7: $20 loss allowed as a deduction, and spread in accordance with subitem 104(17).

Subdivision 230-G balancing adjustment

Applying the method statement in section 230-445 when the forward matures on 1 July 2012:

Step 1(a): $0 (on the assumption the forward matures on 1 July 2012 with fair value of $0).

Step 1(b): $110 (This includes the transitional balancing adjustment amount included so far allowed as a deduction and the decline in fair value from 1 July 2010 to 1 July 2012 which has already been deducted over those two years under the fair value method).

Step 1(c): $0

Step 1(d): $10 (The transitional balancing adjustment amount yet to be allowed as a deduction).

Step 1 result: $120

Step 2(a): $120 (The deemed amount for acquisition in accordance with the assumed application of paragraph 701-55(5A)(b) by paragraph 104B(2)(a)).

Step 2(b): $0

Steps (c) to (e): $0

Step 2 result: $120

Step 3: Subdivision 230-G balancing adjustment of $0 upon maturity.

As such, from the head company's perspective, the forward has an overall loss of $120 over its term, of which a $20 loss was brought to account as the TOFA transitional adjustment; and a $100 loss was brought to account under the fair value tax timing method.

Liabilities that are part of a pre-TOFA joining

2.65 Paragraph 104B(2)(b) ensures that the TOFA consolidation interaction provisions apply for the purposes of working out the TOFA transitional adjustments and applying the TOFA provisions in relation to liabilities that are part of a pre-TOFA joining. ***[Schedule 2, item 5, paragraph 104B(2)(b)]***

2.66 As explained above, the new subsection 715-375(2) determines, for TOFA purposes, the time that the head company starts to have the liability and the amount that the head company is deemed to have received for assuming the liability.

2.67 However, the new subsection 715-375(2) only applies, if the pre-conditions in subsection 715-375(1) are first satisfied. One of these preconditions is that the liability is, or is part of, a Division 230 financial

arrangement of the head company at the joining time (because of the single entity rule).

2.68 In the case of a pre-TOFA joining, it is unclear whether the liability is, or is not part of, a Division 230 financial arrangement of the head company at the joining time as the head company has yet to enter the TOFA regime. Thus, it is unclear whether subsection 715-375(2) applies to transition a liability that the head company assumed as part of a pre-TOFA joining into the TOFA regime.

2.69 The assumed application of section 715-375 to a pre-TOFA joining has the following implications:

- for the purposes of working out the transitional balancing adjustment for a liability:
  - the head company is deemed to start to have the liability at the joining time, which is prior to the head company entering into the TOFA regime (that is, steps 1 to 4 of subitem 104(13) of the TOFA Act); and
  - the head company is deemed by section 715-375 to have received an amount for assuming the liability — this amount is then taken into account in working out what would be the tax outcome if the TOFA provisions had applied to the liability from the time the head company starts to have the liability (that is, steps 1 and 2 of subitem 104(13) of the TOFA Act. Steps 3 and 4 of subitem 104(13) of the TOFA Act are intended to be affected); and
- the head company's deemed receipt of a payment for the liability at the joining time is taken into account in working out the gain or loss from the liability under the TOFA provisions, including the Subdivision 230-G balancing adjustment when the liability ceases to be held by the head company (for example, upon maturity or disposal).

Example 2.4: Derivative liability that the head company assumes as part of a pre-TOFA joining and transitions into the TOFA regime

On 1 July 2008, a joining entity enters into a cash-settlable forward transaction for $0. The term of the forward is four years.

On 1 July 2009, the joining entity becomes a subsidiary member of an existing consolidated group. At the time of joining, the forward has a fair value of –$120. As the forward is fair valued through profit/loss

for accounting purposes, –$120 is also the amount of the liability for tax purposes, applying the fair value tax timing method.

The head company continues to hold the forward until it enters into the TOFA regime on 1 July 2010, which is the start of the head company's first TOFA year. At that time, the fair value of the liability is –$100.

On 1 July 2010, the head company makes an irrevocable election under subitem 104(2) of the TOFA Act to apply the TOFA provisions in relation to all of the financial arrangements it had on 1 July 2010. It also makes a valid fair value tax timing election under Subdivision 230-C.

As such, the liability satisfies the preconditions under the new subitem 104B(1). Paragraph 104B(2)(b) applies in relation to the liability. The assumed application of section 715-375 to the liability has the following consequences:

- for the purposes of applying subitem 104(13) of the TOFA Act to work out the transitional balancing adjustment for the liability, the head company is treated as starting to have the liability at the joining time for receiving a payment equal to the liability's Division 230 starting value at joining time (which, in this case, is -$120); and

- for the purposes of applying section 230-445 to work out the Subdivision 230-G balancing adjustment for the liability when it matures on 1 July 2012, the head company is deemed to have received a payment equal to the forward's Division 230 starting value at the joining time.

Transitional balancing adjustment

Applying this assumption, the result of the transitional balancing adjustment would be as follows:

Step 1: $20 (The increase in fair value from the joining time would have been a gain that would have been made from the forward).

Step 2: $0 (As the subitem 104(13) method statement is to be calculated on the assumption that section 715-375 applied to deem the head company starting to have the liability at the joining time, the increase in fair value of the forward that occurred between 1 July 2008 and 1 July 2009 is ignored for the purposes of step 2).

Step 3: $0 (No amounts have been assessed since the joining time).

Step 4: $0 (No amounts have been deducted since the joining time).

Step 5: $20

Step 6: $0

Step 7: $20 gain included in assessable income, and spread in accordance with subitem 104(17).

Subdivision 230-G balancing adjustment

Applying the method statement in section 230-445 on 1 July 2012, when the forward matures:

Step 1(a): $120 (The deemed assumption in accordance with the assumed application of section 715-375 by paragraph 104B(2)(b)).

Step 1(b): $0

Step 1(c): $0

Step 1(d): $0

Step 1 result: $120

Step 2: $0 (on the assumption that the forward matures on 1 July 2012 with a fair value of $0).

Step 2(b): $110 (The increase in fair value from 1 July 2010 to 1 July 2012, which has already been included as assessable income over those two years under the fair value method and the transitional balancing adjustment amount included so far in assessable income).

Step 2(c): $0

Step 2(d): $10 (The transitional balancing adjustment amount yet to be included in assessable income).

Step 2 result: $120

Step 3: Subdivision 230-G balancing adjustment of $0 upon maturity.

As such, from the head company's perspective, the forward has an overall gain of $120 over its term, of which a $20 gain was and is to be brought to account as the TOFA transitional adjustment; and a $100 gain was brought to account under the fair value tax timing method.

Example 2.5: Foreign currency denominated loan that the head company assumes as part of a pre-TOFA joining and transitions into the TOFA regime

On 1 July 2008, the joining entity enters into a US dollar denominated loan arrangement and received the equivalent of AU$100. The term of the loan is 4 years.

On 1 July 2009, the joining entity becomes a subsidiary member of a consolidated group as a result of an acquisition of all its membership interests.

At the time of joining, the loan has a value of AU$90. The change in the value of the loan from AU$100 to AU$90 is not required to be brought to account for tax purposes.

The head company continues to have the loan until it enters the TOFA regime on 1 July 2010, which is the start of the head company's first TOFA year. At that time, the value of the loan is AU$80. There are no further changes to the value of the loan until settlement.

On 1 July 2010, the head company makes an election under subitem 104(2) of the TOFA Act to apply the TOFA provisions in relation to all of the financial arrangements it had on 1 July 2010. It also makes a valid foreign exchange retranslation tax timing election under Subdivision 230-D.

As such, the liability satisfies the pre-conditions under the new subitem 104B(1). Paragraph 104B(2)(b) applies in relation to the liability. The assumed application of section 715-375 to the liability has the following consequences:

- for the purposes of applying subitem 104(13) of the TOFA Act to work out the transitional balancing adjustment for the liability, the head company is treated as starting to have the liability at the joining time for receiving a payment equal to the liability's Division 230 starting value at the joining time (which, in this case, is AU$90); and
- for the purposes of applying section 230-445 to work out the Subdivision 230-G balancing adjustment for the liability when it matures on 1 July 2012, the head company is deemed to have received a payment equal to the liability's Division 230 starting value at the joining time (that is, AU$90).

Transitional balancing adjustment

Applying this assumption, the result of the transitional balancing adjustment would be as follows:

Step 1: $10 (This is because the subitem 104(13) method statement is to be calculated on the assumption that paragraph 104B(2)(b) applied in relation to the liability at the joining time which resulted in the head company starting to have the liability at that time. As such, the change in AU$ value of the loan that occurred between 1 July 2008 and 1 July 2009 is ignored for the purposes of step 1).

Step 2: $0 (There would be no loss made from the loan had Subdivision 230-D applied in relation to the loan after the joining time).

Step 3: $0 (No amounts have been assessed since the joining time).

Step 4: $0 (No amounts have been deducted since the joining time).

Step 5: $10

Step 6: $0

Step 7: $10 gain is included in assessable income, and spread in accordance with subitem 104(17).

Subdivision 230-G balancing adjustment

Applying the method statement in section 230-445 when the loan is paid out on 1 July 2012:

Step 1(a): $90 (The deemed assumption in accordance with the assumed application of section 715-375 by paragraph 104B(2)(b)).

Step 1(b): $0

Step 1(c): $0

Step 1(d): $0

Step 1 result: $90

Step 2(a): $80 (on the assumption that the loan is settled in full on 1 July 2012).

Step 2(b): $5 (The transitional balancing adjustment amount included so far in assessable income).

Step 2(c): $0

Step 2(d): $5 (The transitional balancing adjustment amount yet to be included as assessable income).

Step 2 result: $90

Step 3: Subdivision 230-G balancing adjustment of $0 (when the liability is settled).

As such, from the head company’s perspective, the loan has an overall gain of $10 over its term, of which a $10 gain was brought to account

as the TOFA transitional adjustment; and no amount was brought to account under the Subdivision 230-G balancing adjustment.

Liabilities that are part of a pre-TOFA formation

2.70 For liabilities that are part of a pre-TOFA formation, the amount of payment that the head company is deemed to have received for starting to have the liability is not determined in accordance with section 715-375. The amount is deemed to be the amount of consideration that the joining entity would need to provide if it ceased holding the liability just before the pre-TOFA formation, without an amount being assessable income of, or deductible to, the joining entity. ***[Schedule 2, item 5, subitems 104B(8) and (9)]***

2.71 The deemed amount for starting to have liabilities that are part of a pre-TOFA formation is different, because formation does not involve the head company acquiring the shares of the joining entity at the joining time, unlike in the merger or takeover scenario. Under the consolidation regime, while the unrealised gain or loss on an asset that is part of a pre-TOFA formation is taken into account in working out the allocable cost amount (within the meaning of section 705-60) at the joining time, the unrealised gain or loss on a liability that is part of a pre-TOFA formation may not be recognised for tax purposes if the head company does not recognise this unrealised gain or loss for tax purposes.

2.72 To ensure that the head company recognises these unrealised gains or losses for tax purposes, subitem 104B(9) sets the amount that the head company is deemed to have received for starting to have the liability to be the joining entity's tax carrying value for the liability. This means that the unrealised gain or loss associated with the liability at the joining time is not attributed to the joining entity at the joining time but is instead transferred to the head company.

Example 2.6: Derivative liability that the head company assumes as part of a pre-TOFA formation and transitions into the TOFA regime

A joining entity is a wholly-owned subsidiary of another entity. The other entity is the holding company of a wholly owned group.

On 1 July 2008, the joining entity enters into a cash-settlable swap transaction for $0. The term of the swap is four years.

On 1 July 2009, the joining entity becomes a subsidiary member of a tax consolidated group as the result of the holding company electing to form the tax consolidated group. The rules in Subdivision 705-B had effect in relation to the joining entity becoming a subsidiary member of the group.

At the time of joining, the swap liability has a fair value of –$100. The swap is fair valued through profit/loss for accounting purposes; and no amount is required to be brought to account for tax purposes prior to the joining time.

The head company continues to hold the swap liability until it enters into the TOFA regime on 1 July 2010, which is the start of the head company's first TOFA year. At that time, the fair value of the liability is –$140. There are no further changes to the fair value of the swap until it is settled.

On 1 July 2010, the head company makes an election under subitem 104(2) of the TOFA Act to apply the TOFA provisions in relation to all of the financial arrangements it had on 1 July 2010. It also makes a valid fair value tax timing election under Subdivision 230-C.

The liability satisfies the conditions under subitem 104B(1). However, subitem 104B(8) applies in relation to the liability, as Subdivision 705-B had effect in relation to the joining entity becoming a subsidiary member of the group. As such, the assumed application of subitem 104B(9) to the liability means that for the purposes of applying subitem 104(13) of the TOFA Act and Division 230, the head company is treated as if it assumed the liability at the joining time for receiving a payment equal to the amount that the joining entity would need to provide if it were to cease holding the liability just before the joining time, without an amount being assessable or deductible.

On this basis, the head company is treated as if it assumed the liability for $0.

Transitional balancing adjustment

Applying subitem 104B(9), the result of the transitional balancing adjustment is as follows:

Step 1: $0 (There were no amounts that would be assessable had Subdivision 230-C applied in relation to the swap from the joining time).

Step 2: $40 (This is because the subitem 104(13) method statement is to be calculated on the assumption that subitem 104B(9) applied in relation to the liability at the joining time which resulted in the head company starting to have the liability at that time. As such, the change in the fair value of the swap that occurred between 1 July 2008 and 1 July 2009 is ignored for the purposes of step 2).

Step 3: $0 (No amounts have been assessed since the joining time).

Step 4: $0 (No amounts have been deducted since the joining time).

Step 5: $0

Step 6: $40

Step 7: $40 loss allowed as a deduction, and spread in accordance with subitem 104(17).

Subdivision 230-G balancing adjustment

Applying the method statement in section 230-445 when the swap liability is paid out on 1 July 2012 (as there was no further movement in the fair value from the start of the head company's first TOFA year):

Step 1(a): $0 (Subitem 104B(9) operates such that the liability has been assumed for a payment equal to $0).

Step 1(b): $20 (The transitional balancing adjustment amount included so far allowed as a deduction).

Step 1(c): $0

Step 1(d): $20 (The transitional balancing adjustment amount yet to be allowed as a deduction).

Step 1 result: $40

Step 2(a): $140 (on the assumption that the swap liability is paid out in full on 1 July 2012).

Step 2(b): $0

Steps (c) to (e): $0

Step 2 result: $140

Step 3: Subdivision 230-G balancing adjustment of $100 loss (when the liability is paid out).

As such, from the head company's perspective, the swap has an overall loss of $140 over its term, of which a $40 loss was brought to account as the TOFA transitional adjustment; and a $100 loss was brought to account under the Subdivision 230-G balancing adjustment.

No application of the alternative method to work out the transitional balancing adjustments for assets and liabilities that are part of a pre-TOFA joining

2.73 Subitem 104B(3) ensures that the alternative method as outlined in subitems 104(14) and (15) of the TOFA Act cannot be used in working out the transitional balancing adjustments for liabilities and assets that the

head company acquired/assumed as part of a pre-TOFA joining and elected to transition into the TOFA regime. ***[Schedule 2, item 5, subitem 104B(3)]***

2.74 This is because the alternative method does not provide a good approximation of the primary method for these assets and liabilities. As such, the head company should use the primary method to calculate the transitional balancing adjustments for these financial arrangements.

2.75 Under the alternative method, the transitional balancing adjustment for a financial arrangement is worked out by grossing up an amount related to the financial arrangement in the taxpayer's deferred tax asset or deferred tax liability accounts. The deferred tax asset or deferred tax liability amounts essentially represent the deductible temporary difference or the taxable temporary difference as defined in the accounting standards: the difference represents a comparison of the tax carrying value with the accounting carrying value. Normally, the grossed up deferred tax asset and deferred tax liability amounts are a good approximation of the transitional balancing adjustments that would have been worked out under the primary method.

2.76 However because deferred tax asset and deferred tax liability calculations do not take into account 'notional tax events', in some cases the alternative method does not provide a reasonable approximation of the amount that would be calculated under the primary method.

2.77 In the case of an asset or liability that the head company acquires/assumes as part of a pre-TOFA joining, the alternative method does not provide a reasonable approximation of the transitional balancing adjustments worked out under the primary method because the DTA/DTL amounts are accumulated from the time the joining entity starts to have the asset or liability. The deferred tax asset and deferred tax liability amounts reflect the deferred tax effect for the entire period from when the joining entity started to have the financial arrangement until the head company enters into the TOFA regime (unlike the primary method which calculates the difference between actual tax outcomes under the pre-TOFA tax laws and the notional tax outcomes under the TOFA regime from the date the head company started to have the liability until the time the head company started to apply the TOFA provisions).

Assets that are part of a pre-TOFA joining — adjustments for the difference between tax cost setting amount and TOFA starting value

2.78 Subitems 104B(4) to (7) replicate the section 701-61 adjustment for assets that the head company acquired as part of a pre-TOFA joining and to which it has elected to apply the fair value, financial reports or

retranslation tax timing method. ***[Schedule 2, item 5, subitems 104B(4) to 104B(7)]***

2.79 For assets that the head company acquired as part of a joining/consolidation event and for which the fair value, reliance on financial reports or retranslation tax timing method applies, section 701-61 requires the head company to work out the difference between the tax cost setting amount and the Division 230 starting value of the asset, and to spread the difference over four years starting from the income year in which the single entity rule first applied.

2.80 However, section 701-61 may not apply to assets that the head company acquired as part of a pre-TOFA joining, which it has elected to bring into the TOFA regime and apply the fair value, financial reports or retranslation tax timing method to. This is because, as explained in paragraph 2.63, it is unclear whether subsection 701-55(5A) can apply at a joining time prior to the head company entering the TOFA regime.

2.81 Subitems 104B(4) to (7) are intended to achieve the same outcome as provided under section 701-61 for assets that the head company acquire/assumes as a result of a pre-TOFA joining, except the difference between the asset's tax cost setting amount and the Division 230 starting value is to be spread over four years, starting from the head company’s first TOFA year, as opposed to the income year in which the joining occurred.

2.82 Note that, as for the adjustments worked out under section 701-61, the adjustments worked out under these amendments are not taken into account for working out other balancing adjustments under the TOFA provisions. This is because these amounts account for the difference between the tax cost setting amount and the Division 230 starting value of the financial arrangement, which are unrelated to the gain or loss made from the financial arrangement.

Example 2.7: Derivative asset that is part of a pre-TOFA joining, transitioned into the TOFA regime and to which the head company applies the fair value, reliance on financial reports or retranslation tax timing method

> This is a continuation of Example 2.3.
>
> On 1 July 2009, the head company acquires all of the joining entity’s membership interests for $1,050. Consequently, the joining entity joins head company’s consolidated group.
>
> The joining entity has two assets, the forward which has a fair value of $120 and cash at bank of $1,000.

In setting the tax costs of the assets of the joining entity, assuming the joining entity has no liabilities, the allocable cost amount (ACA) for the joining entity is $1,050.

Cash at bank is a retained cost base asset and has its tax cost set at $1,000.

The remaining ACA of $50 is allocated to the forward which is a reset cost base asset. The tax cost of the forward is set at $50, despite the fact that its fair value at the joining time is $120.

Applying subitem 104B(5), the Division 230 starting value at the joining time is $120. The tax cost setting amount at the joining time was $50. This means that the Division 230 starting value at the joining time exceeds the tax cost setting amount. Because of this, $17.50 (that is, 25 per cent of this excess) is to be included in the head company's assessable income for:

- the income year that started on 1 July 2010; and
- each of the three subsequent income years.

Carving out assets and liabilities that are subject to private rulings or written advice from TOFA transitional amendments

2.83 The amendments to the TOFA transitional provisions in item 104B do not apply to assets that are subject to certain prior private ruling or written advice under an Annual Compliance Arrangement issued by the Commissioner, and liabilities that are the same kind of financial arrangements as the carved out assets. ***[Schedule 2, item 5, item 104C]***

Assets that are carved out

2.84 To be carved out of the application of the amendments to the TOFA transitional provisions, an asset must satisfy the following conditions:

- assuming item 51 of Schedule 2 to this Bill commences at the commencement of this item, the asset would be carved out from the application of Schedule 2 to this Bill because of the application of the item to a private ruling or written advice under an Annual Compliance Arrangement ***[Schedule 2, item 5, paragraphs 104C(1)(a) and (b)]***;
- the asset is, or is part of, a financial arrangement at the start of the head company's first TOFA year ***[Schedule 2, item 5, paragraphs 104C(1)(c) and (e)]***;

- the asset satisfies subitem 104B(1) ***[Schedule 2, item 5, paragraph 104C(1)(d)]***; and
- the ruling or advice has effect in relation to the asset for the head company's first TOFA year ***[Schedule 2, item 5, paragraph 104C(1)(f)].*** That is, the ruling provided the tax outcome associated with the application of subsection 701-55(5C) or 701-55(6) in relation to the asset for the head company's first TOFA year.

2.85 If these conditions are met, item 104B does not apply to the asset. ***[Schedule 2, item 5, paragraph 104C(2)]***

Example 2.8: Assets that are carved out from item 104B

On 1 July 2008, an entity enters into two interest rate swaps (on similar terms) and two cash-settlable forwards. The value of both of these swaps at the time they are entered into is $0, and the value of the forwards is also $0.

On 1 July 2009, the entity joins a consolidated group. Due to changes in interest rates, the value of the swaps at the time of joining is:

- $120 (the swap asset); and
- –$120 (the swap liability).

Additionally, on 1 July 2009, because of changes in the price of the subject-matter of the forwards, their value is:

- $10 (the forward asset); and
- –$10 (the forward liability).

1 July 2010 is the start of the head company's first applicable income year as defined in item 102 of the TOFA Act.

Additionally, on 1 July 2010, the head company makes an election under subitem 104(2) of the TOFA Act to apply the TOFA provisions in relation to all of the financial arrangements it had on 1 July 2010.

This means that Division 230 applies in relation to the two swaps, and the two forwards.

Before 31 March 2011, the head company receives advice under a private binding ruling as to the application of subsection 701-55(6) in relation to its swap asset for the 2008-09 to 2018-19 income years. The ruling states that certain amounts were allowable as deductions in respect of those swap assets.

No ruling is received before 31 March 2011 in relation to the forwards.

Item 104B of the TOFA Act does not apply in relation to its swap asset (see sub-item 104C(2) of the TOFA Act), because (as per subitem 104C(1) of the TOFA Act):

- item 51 of Schedule 2 to this Bill applies in relation to the ruling that the head company receives and the swap asset is carved out from the application of item 50 of Schedule 2 to this Bill because of the ruling or written advice;
- the effect of the ruling is in relation to the swap asset for the 2010-11 income year (amongst others);
- the swap asset is a financial arrangement at the start of the 2010-11 income year;
- the requirements under item 104B(1) are satisfied in relation to the asset;
- the head company is the one mentioned in that subitem; and
- the 2010-11 income year is the head company's first applicable income year.

However, the head company must apply item 104B in relation to the forward asset, because the ruling, to the extent that item 51 of Schedule 2 to this Bill applies, does not have any effect in relation to the forward asset (see paragraph 104C(1)(b)).

Liabilities that are carved out of item 104B

2.86 To be carved out of the application of the amendments to the TOFA transitional provisions, a liability must satisfy the following conditions:

- the liability is, or is part of, a financial arrangement of the same kind as the financial arrangement that an asset, that is carved out under subitem 104C(1), is, or is part of ***[Schedule 2, item 5, paragraphs 104C(3)(a), (b) and (c)].*** For example, interest rate swaps that are in the money and that are out of the money are the same kind of financial arrangements, whereas interest rate swaps that are in the money and cross currency swaps that are out of the money are different kinds of financial arrangements;
- the liability is, or is part of, a financial arrangement at the start of the head company's first applicable income year ***[Schedule 2, item 5, paragraphs 104C(3)(b) and (e)]***; and

- the liability satisfies subitem 104B(1) ***[Schedule 2, item 5, paragraph 104C(3)(d)].***

2.87 If these conditions are met, item 104B does not apply to the liability. ***[Schedule 2, item 5, paragraph 104C(4)]***

Example 2.9: Liabilities that are carved out of item 104B

This is a continuation of Example of 2.8.

As in that example, item 104B does not apply to the entity's swap asset, item 104B also does not apply to its swap liability, because (as per subitem 104C(3)):

- the swap liability is a financial arrangement as at the start of the 2010-11 income year;
- the swap liability is the same kind of financial arrangement as the swap asset to which subitem 104(2) applies;
- the requirements are under subitem 104B(1) are satisfied in relation to the liability; and
- the head company would be the one mentioned in paragraph 104C(1)(e).

However, the head company will need to apply item 104B in relation to the forward liability, because the forward liability is not a financial arrangement of the same kind as the swap asset (see paragraph 104C(3)(c)).

Application and transitional provisions

2.88 These amendments commence on 26 March 2009, immediately after commencement of the provisions they are amending. ***[Clause 2, item 9 in the table]***

2.89 The amendments to the TOFA consolidation interaction provisions apply to taxpayers for the same income years as the provisions they are amending. ***[Schedule 2, item 6]***

2.90 The amendments commence and apply retrospectively because the amendments are largely technical amendments to correct parts of the law that did not give proper effect to the policy as stated in the TOFA explanatory memorandum.

2.91 The TOFA regime is a new and very complex part of the tax laws that commenced on 26 March 2009 and applies mandatorily for income years commencing on or after 1 July 2010. Shortly after its introduction, the Government made it clear that technical amendments and further integrity measures may be necessary to ensure the law operates as intended. (see the then Assistant Treasurer's Media Releases No. 103 of 4 December 2008 and No. 022 of 26 March 2009) In addition, the Government announced its intention to make retrospective legislative clarification where it became aware that the law could produce unintended outcomes (see the then Assistant Treasurer's Media Release No. 005 of 12 January 2010).

2.92 In this regard, all announced amendments to the TOFA Act (see the then Assistant Treasurers' Media Releases' No. 043 of 4 September 2009, No. 145 of 29 June 2010 and No. 019 of 29 November 2010) have retrospective effect from the start of those provisions, regardless of whether they benefited or adversely affected taxpayers.

2.93 Like the TOFA provisions, the amendments apply symmetrically to gains and losses from financial arrangements whether they are assets or liabilities. As such, the amendments may benefit or adversely affect different taxpayers, depending on their circumstances.

STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Amendments to the TOFA consolidation interaction and transitional provisions

2.94 This Schedule is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview

2.95 Schedule 2 to this Bill amends the TOFA consolidation interaction provisions in the ITAA 1997 and the transitional provisions in the TOFA Act.

2.96 The amendments to the TOFA consolidation interaction provisions ensure that the tax treatment of financial arrangements that are part of a joining/consolidation event is consistent with the TOFA tax timing rules and that the tax treatment of liabilities that are, or are part of, a financial arrangement, takes into account changes in the value of the liability other than the repayment of the liability.

2.97 The amendments to the TOFA transitional provisions ensure that the TOFA consolidation interaction provisions apply where:

- a joining/consolidation event occurred prior to a consolidated group starting to apply the TOFA provisions in relation to its financial arrangements; and
- the head company has made an election to apply the TOFA provisions to its existing financial arrangements.

Human rights implications

2.98 This Schedule does not engage any of the applicable rights or freedoms.

Conclusion

2.99 This Schedule is compatible with human rights as it does not raise any human rights issues.

Assistant Treasurer, the Hon David Bradbury

Chapter 3
Consolidation

Outline of chapter

3.1 Schedule 3 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to modify the consolidation tax cost setting and rights to future income rules so that the tax outcomes for consolidated groups are more consistent with the tax outcomes that arise when assets are acquired outside the consolidation regime.

Context of amendments

3.2 The consolidation regime aims to reduce tax compliance costs and improve the integrity of the income tax system by allowing a group of corporate entities the choice to lodge a single income tax return if, broadly, they are all wholly owned by an Australian resident company. The head company lodges the income tax return for the group, while the subsidiaries lose their individual income tax identities.

3.3 When a company acquires an asset, the cost of the asset can be recognised in different ways under the income tax law. When and how the cost is used will depend on the nature of the asset and the circumstances in which it is acquired. For example:

- in the case of a depreciating asset, the tax cost is deducted over the life of the asset;
- in the case of a capital gains tax (CGT) asset, the tax cost is recognised when the asset is sold (or when another CGT event happens to the asset);
- in the case of some other assets, the tax cost may be recognised when the asset is acquired, as income is derived from the asset, or when the asset is sold (depending on circumstances).

3.4 When a consolidated group acquires a company, the shares in the acquired company cease to be recognised for taxation purposes and the company's assets effectively become assets of the head company.

3.5 The tax costs of those assets are reset at an amount that reflects their respective share of the group's cost of acquiring the joining company (based on the relative market values of those assets). However, some specified assets (such as cash) retain their original tax cost.

3.6 A specific provision in the income tax law (section 701-55 of the ITAA 1997) deals with how the reset tax cost for an asset is used when applying other provisions of the income tax law to that asset. If a provision in the income tax law that is not specifically mentioned in that provision applies to the asset, the residual tax cost setting rule (subsection 701-55(6)) applies to specify the use of the reset tax cost.

3.7 Amendments to the consolidation regime made by the *Tax Laws Amendment (2010 Measures No. 1) Act 2010* broadened the scope of the residual tax cost setting rule and introduced the rights to future income rule (subsection 701-55(5C)). Those amendments sought to remove uncertainty in the law by clarifying that, for some assets, the reset tax cost of the asset (rather than its original tax cost) is used when a taxing point later arises for the asset. They also clarified the tax outcomes for assets that are rights to future income (such as an entitlement to unbilled income). The amendments applied from 1 July 2002 as they were thought to be merely returning the regime to its originally stated intent.

3.8 Shortly after passage of those amendments, it became clear that the new rules, combined with Taxation Ruling TR 2004/13 on the meaning of an asset for consolidation purposes and a change to Australian Accounting Standard AASB 138 on intangible assets, could result in the recognition of the tax costs of some assets being brought forward in an unanticipated way.

3.9 For example, issues arose about whether a joining entity's original goodwill asset (which is a CGT asset) could be broken into a range of intangible assets (which have no actual tax cost and are not usually recognised for tax purposes), and whether some depreciating assets and some CGT assets could be reclassified as rights to future income or revenue assets. To the extent that these assets could be successfully identified and reclassified, tax recognition for the reset tax costs would be brought forward. In this way unintended windfalls could arise for some taxpayers.

3.10 Consequently, on 30 March 2011, the then Assistant Treasurer asked the Board of Taxation to examine the operation of the residual tax cost setting and rights to future income rules (see the then Assistant Treasurer's Media Release No. 045 of 30 March 2011).

3.11 The Board of Taxation concluded that the scope of the rules, as enacted, appeared to be broader than was originally intended at the time of

their announcement in 2005. These rules, combined with the effect of other long standing elements of the consolidation regime, could allow consolidated groups to access deductions that are not available to taxpayers outside the consolidation regime. Consequently, the revenue impact of the rules was likely to be significantly larger than expected.

3.12 These amendments respond to the need to protect a significant amount of revenue that would otherwise be at risk, and to make the tax outcomes for consolidated groups more consistent with those for entities outside consolidation.

Summary of new law

3.13 Schedule 3 to this Bill amends the consolidation provisions in the income tax law to modify the consolidation tax cost setting and rights to future income rules and to make the tax outcomes for consolidated groups more consistent with the tax outcomes that arise when assets are acquired outside the consolidation regime.

3.14 The changes affecting a corporate acquisition will depend on the time when the acquisition took place. That is, different changes apply to acquisitions that took place before 12 May 2010 (when the law was passed by both Houses of Parliament), after 30 March 2011 (when the Board of Taxation was asked to review the rules) and the intervening period.

3.15 As the 2010 amendments operated with effect back to 2002, some of the further changes (the pre-rules) also need to operate with effect from that date. These changes prevent the retrospective operation of unintended effects of, and perceived weaknesses in, the law. In particular, the pre-rules, which apply broadly to the period before 12 May 2010, will restore the tax cost setting rules that operated prior to the 2010 amendments (the original tax cost setting rules), with modifications to:

- limit deductions for rights to future income to unbilled income assets;
- ensure that a deduction is allowed for the reset tax costs for consumable stores; and
- treat certain assets as goodwill.

3.16 The changes for the intervening period (the interim rules) will protect taxpayers who acted on the basis of the current law before the Board of Taxation review was announced. These rules, which apply

broadly to the period between 12 May 2010 and 30 March 2011, will restore the current 2010 residual tax cost setting and rights to future income rules, with modifications to:

- treat certain assets as goodwill;
- ensure that no value is attributed to certain contractual rights to future income; and
- ensure that the reset tax costs for consumable stores are deductible.

3.17 The prospective changes (the prospective rules) primarily implement the recommendations made by the Board of Taxation to improve the operation of the consolidation tax cost setting rules. These changes will increase certainty for taxpayers and make the tax outcomes for consolidated groups more consistent with the tax outcomes that arise when assets are acquired by entities outside the consolidation regime. In particular, the prospective rules, which apply broadly to the period after 30 March 2011, will:

- restrict the operation of the tax cost setting rules to CGT assets, revenue assets, depreciating assets, trading stock and Division 230 financial arrangements;
- apply a business acquisition approach to the residual tax cost setting rule;
- ensure that the reset tax costs for rights to future income that are work in progress (WIP) amount assets and consumable stores are deductible; and
- treat rights to future income, other than WIP amount assets, as retained cost base assets.

Comparison of key features of new law and current law

New law	*Current law*
The changes affecting a corporate acquisition will depend on the time when the acquisition took place. That is, different changes apply to acquisitions that took place before 12 May 2010 (the pre-rules), after 30 March 2011 (the prospective	When a company acquires an asset, the cost of the asset can be recognised in different ways under the income tax law. When and how the cost is recognised will depend on the nature of the asset and the circumstances in which it is acquired.

New law	Current law
rules) and the intervening period (the interim rules). The pre-rules, which apply broadly to the period before 12 May 2010, will restore the original tax cost setting rules that operated prior to the 2010 amendments, with modifications to: • limit deductions for rights to future income to unbilled income assets; • ensure that a deduction is allowed for the reset tax costs for consumable stores; and • treat certain assets as goodwill. The interim rules, which apply broadly to the period between 12 May 2010 and 30 March 2011, will restore the current 2010 residual tax cost setting and rights to future income rules, with modifications to: • treat certain assets as goodwill; • ensure that no value is attributed to certain contractual rights to future income; and • ensure that the reset tax costs for consumable stores are deductible. The prospective rules, which apply broadly to the period after 30 March 2011, will: • restrict the operation of the tax cost setting rules to CGT assets revenue assets, depreciating assets, trading stock and Division 230 financial arrangements; • apply a business acquisition approach to the residual tax cost setting rule; • ensure that the reset tax costs for rights to future income that are WIP amount assets and consumable stores are deductible; and • treat rights to future income, other than WIP amount assets, as	When a consolidated group acquires a company, the shares in the acquired company cease to be recognised for taxation purposes and the company's assets effectively become assets of the head company. The tax costs of those assets are reset at an amount that reflects their respective share of the group's cost of acquiring the joining company. However, some specified assets (such as cash) retain their original tax cost. A specific provision in the income tax law (section 701-55 of the ITAA 1997) deals with how the reset tax cost for an asset is used when applying other provisions of the income tax law to that asset. If the asset is a right to future income, the reset tax cost is deductible over, broadly, the lesser of the period of the relevant contract or 10 years. If the residual tax cost setting rule applies to specify the use of the reset tax cost, other provisions of the income tax law apply to the asset as if the head company had incurred expenditure to acquire the asset at the joining time.

New law	Current law
retained cost base assets.	

Detailed explanation of new law

3.18 The changes affecting a corporate acquisition will depend on the time when the acquisition took place. That is, different changes apply, with certain exceptions, to:

- acquisitions that took place before 12 May 2010 — in this case the pre-rules apply;
- acquisitions that took place between 12 May 2010 and 30 March 2011 — in this case the interim rules apply; and
- acquisitions that took place on or after 31 March 2011 — in this case the prospective rules apply.

3.19 The pre-rules amend the operation of the current law.

3.20 The interim rules amend the operation of the current law as modified by the pre-rules.

3.21 The prospective rules amend the operation of the current law as modified by both the pre-rules and the interim rules.

The pre-rules

3.22 The pre-rules amend the operation of the current law for, broadly, the pre-12 May 2010 period. These amendments:

- restore the original residual tax cost setting rule;
- limit deductions for rights to future income to unbilled income assets;
- ensure that a deduction is allowed for the reset tax costs for consumable stores; and
- treat certain assets as goodwill.

3.23 The objective of the pre-rules is to prevent the retrospective operation of unintended effects of, and perceived weakness in, the 2010 amendments to the law. The pre-rules are necessary to protect a significant amount of revenue that would otherwise be at risk. However,

consistent with the announcement for these changes, the pre-rules ensure that the reset tax cost for consumable stores and for unbilled income assets are deductible.

Original residual tax cost setting rule restored

3.24 When an entity joins a consolidated group, the tax costs of its assets are reset under the tax cost setting rules.

3.25 Section 701-55 specifies how the reset tax cost for an asset is used when applying other provisions of the income tax law to that asset. If a provision in the income tax law that is not specifically mentioned in section 701-55 applies to the asset, the residual tax cost setting rule (subsection 701-55(6)) applies to specify the use of the reset tax cost.

3.26 The 2010 amendments to the consolidation regime broadened the scope of the residual tax cost setting rule. The amendments applied from 1 July 2002 as they were thought to be merely returning the regime to its originally stated intent.

3.27 The 2010 amendments have had a broader impact than expected. Therefore, to prevent taxpayers from obtaining a windfall gain from those amendments in the pre-12 May 2010 period, the pre-rules modify the current law to restore the original residual tax cost setting rule. ***[Schedule 3, item 2, subsection 701-55(6) of the pre-rules]***

3.28 The operation of the original residual tax cost setting rule is explained in paragraph 2.57 of the explanatory memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002. In essence, that paragraph states that, in setting the cost for tax purposes of an asset which is not a depreciating asset, trading stock, a CGT asset or an asset covered by another specific provision in section 701-55, the provisions of the income tax law apply as though the asset's cost is reset.

3.29 In addition, paragraph 5.20 of that explanatory memorandum, which relates to the operation of the tax cost setting rules, states that:

> The set cost for an asset (the tax cost setting amount) will be the relevant 'cost' for all income tax purposes including for the purposes of the CGT, capital allowance and trading stock provisions.

3.30 Consequential amendments modify the heading to section 701-56 and remove subsections 701-56(1) and (2). ***[Schedule 3, items 3 and 4, heading to section 701-56]***

Rights to future income deductions limited to unbilled income assets

3.31 The 2010 amendments to the consolidation regime introduced the rights to future income rules (subsection 701-55(5C) and sections 701-90, 716-405 and 716-410). Those rules allowed consolidated groups to deduct the reset tax cost for a right to future income asset over, broadly, the lesser of the period of the relevant contract or 10 years. The amendments applied from 1 July 2002.

3.32 The 2010 amendments have had a broader impact than expected and unintentionally gave consolidated groups an advantage over other taxpayers. Therefore, to prevent consolidated groups from obtaining a windfall gain from those amendments in the pre-12 May 2010 period, deductions for the reset tax cost for rights to future income will be limited to unbilled income assets. This is consistent with the announcement that led to the 2010 amendments.

3.33 That is, if an entity joins a consolidated group holding an unbilled income asset that is expected to be included in the head company's assessable income after the joining time, then the head company will be able to apply section 716-405 to deduct the reset tax cost for the asset. ***[Schedule 3, item 1, subsection 701-55(5C) of the pre-rules]***

3.34 Under the pre-rules, a ***right to future income*** is a valuable right (including a contingent right) to receive an amount for the performance of work or services or the provision of goods if:

- the valuable right forms part of a contract or agreement;
- the market value of the valuable right (taking into account all the obligations and conditions relating to the right) is greater than nil; and
- the valuable right is neither a Division 230 financial arrangement nor part of a Division 230 financial arrangement.

[Schedule 3, items 6 and 13, subsection 701-63(5) of the pre-rules and the definition of 'right to future income' in subsection 995-1(1)]

3.35 This definition of right to future income is substantially the same as the current definition in subsection 701-90(1). Therefore, a consequential amendment is made to remove section 701-90. ***[Schedule 3, item 7]***

3.36 Under the pre-rules, an asset is a ***non-deductible right to future income*** if it is a right to future income that is not an unbilled income asset.

[Schedule 3, items 6 and 12, subsection 701-63(3) of the pre-rules and the definition of 'non-deductible right to future income' in subsection 995-1(1)]

3.37 An asset that is a right to future income is an ***unbilled income asset*** if:

- the asset is in respect of work (but not goods) that has been performed or partially performed by an entity for another entity where a recoverable debt has not yet arisen in respect of the work; or
- an asset that is in respect of goods (other than trading stock) or services that have been provided by an entity for another entity where a recoverable debt has not yet arisen in respect of the goods or services.

[Schedule 3, items 6 and 14, subsection 701-63(5) of the pre-rules and the definition of 'unbilled income asset' in subsection 995-1(1)]

3.38 That is, an asset held by a joining entity will be an unbilled income asset where:

- a joining entity has performed or partially performed work, or provided goods (other than trading stock) or services, for another entity before the joining time; and
- at the joining time, a recoverable debt has not yet arisen in respect of the work, goods or services.

3.39 If an entity joins a consolidated group holding an unbilled income asset and section 716-410 covers the asset, then section 716-405 will apply to allow a deduction for the reset tax cost for the asset. ***[Schedule 3, item 1, subsection 701-55(5C)]***

3.40 Section 716-410 covers an asset if:

- the asset is a right to future income;
- the asset is held by an entity just before the time that it became a subsidiary member of a consolidated group;
- it is reasonable to expect that an amount attributable to the asset will be included in the assessable income of the entity or any other entity after the joining time; and

- the asset is not a financial arrangement that is covered by the taxation of financial arrangement provisions in Division 230 (disregarding the operation of section 230-455).

[Schedule 3, item 10, section 716-410]

3.41 Section 716-405 allows a deduction for the tax cost setting amount if:

- an entity becomes a subsidiary member of a consolidated group; and
- subsection 701-55(5C) applies in relation to the asset — that is, the asset is an unbilled income asset that is covered by section 716-410.

[Schedule 3, item 9, subsection 716-405(1) of the pre-rules]

3.42 The deduction will be available to the entity that is qualified for a deduction under subsection 716-405(5) for the unbilled income asset. In most cases this will be the head company of a consolidated group that holds the asset because of the single entity rule (subsection 701-1(1)). However, if an entity ceases to be a member of the consolidated group and takes the right to future income asset with it, the leaving entity will be entitled to the deduction. ***[Schedule 3, item 9, subsections 716-405(2) and (5) of the pre-rules]***

3.43 If the head company expects that a recoverable debt will arise in respect of the work, goods or services in relation to the unbilled income asset within 12 months of the joining time, the head company will be able to deduct the unexpended tax cost setting amount for the unbilled income asset in the income year in which the joining time occurs. ***[Schedule 3, item 9, paragraph 716-405(2)(a) of the pre-rules]***

3.44 If a recoverable debt in respect of the work, goods or services in relation to the unbilled income asset arises more than 12 months after the joining time, the entity that is qualified for a deduction will be able to deduct, in the income year in which the recoverable debt arises, the lesser of:

- the unexpended tax cost setting amount for the asset for the income year;
- the total of the recoverable debts.

[Schedule 3, item 9, paragraph 716-405(2)(b) of the pre-rules]

3.45 The ***unexpended tax cost setting amount*** for the unbilled income asset for an income year is the tax cost setting amount for the asset reduced by the amounts (if any) of all deductions under section 716-405 in respect of the asset for previous income years. ***[Schedule 3, item 9, paragraph 716-405(4)(a) of the pre-rules]***

3.46 In addition, in determining the amount of a deduction for a right to future income asset for an income year for an entity that ceased to be a subsidiary member of the group in that income year, the tax cost setting amount is reduced by the amount (if any) that the head company of the group can deduct under section 716-405 in respect of the asset for that income year. ***[Schedule 3, item 9, paragraph 716-405(4)(b) of the pre-rules]***

3.47 An amount that is deducted under section 716-405 for the tax cost setting amount for the unbilled income asset:

- cannot be deducted under any other provision in the income tax law;
- is not taken into account in determining the amount included in assessable income of the head company or an entity that has ceased to be a member of the group for any income year for the asset;
- is not taken into account in determining the amount of a deduction for the head company or an entity that has ceased to be a member of the group for any income year for the asset; and
- is not taken into account in working out any of the elements of the CGT cost base of the asset.

[Schedule 3, item 9, subsection 716-405(6) of the pre-rules]

3.48 Note that, to ensure consistency between the pre-rules and the interim rules, there is no subsection 716-405(3) in the pre-rules. This subsection is reinserted under the interim rules.

3.49 If a right to future income that is an unbilled income asset is held by an entity that is already owned by the group (that is, in a formation case), the asset will be a retained cost base asset, with a tax cost setting amount equal to the joining entity's terminating value for the asset. ***[Schedule 3, item 8, paragraph 705-25(5)(d) of the pre-rules]***

Consumable stores are deductible

3.50 A primary objective of broadening the scope of the residual tax cost setting rule was to ensure that deductions could be claimed under the

general deduction provision (section 8-1) for the reset tax costs of consumable stores.

3.51 Therefore, consistent with the announcement that led to the 2010 amendments, the general deduction provision will apply to allow a deduction for the reset tax cost for consumable stores.

3.52 Consequently, when an entity joins a consolidated group holding an asset that is consumable stores, for the purposes of applying the general deduction provision, the head company will be taken to have incurred an outgoing at the joining time in acquiring the asset for an amount equal to the reset tax cost for the asset. ***[Schedule 3, item 1, subsection 701-55(5D)]***

Certain assets treated as goodwill

3.53 The pre-rules will treat certain assets as forming part of the goodwill asset of a business of a joining entity. The assets which are treated as part of the goodwill of a business may include:

- some assets which are already legal goodwill under general principles; and
- some assets which are not legal goodwill.

3.54 That is, under the pre-rules, for the purposes of applying the consolidation provisions in Part 3-90 to an entity that becomes a subsidiary member of a consolidated group:

- the goodwill of a business of the joining entity is treated as a single asset;
- an asset of that business that is an asset forming part of goodwill is treated as being part of that single asset; and
- as a result, an asset forming part of goodwill is not treated as a separate asset.

[Schedule 3, item 6, subsections 701-63(1) and (2) of the pre-rules]

3.55 If the joining entity has not allocated allocable cost amount to a goodwill asset, the tax cost setting amounts for the assets treated as forming part of goodwill will effectively be the tax cost setting amount for the goodwill asset of each relevant business of the joining entity.

3.56 Some provisions in Part 3-90 specify the treatment of goodwill in specific circumstances. For example, subsections 705-35(3)

and 711-25(2) specify the treatment of synergistic goodwill. The specific operation of those provisions will not be affected by section 701-63.

3.57 In addition, a goodwill asset of a joining entity that is a life insurance company or a general insurance company that demutualised before the joining time is treated as a retained cost base asset (paragraph 713-515(1)(c) and section 713-705). Specific provisions to clarify the interaction between those provisions and section 701-63 will be introduced in a later bill.

3.58 A goodwill asset is a CGT asset. Taxation Ruling TR 1999/16 outlines how the CGT provisions apply to goodwill assets. Applying that ruling, the tax costs allocated to these assets will be recognised only when, broadly:

- a subsidiary member leaves the group taking the goodwill asset with it;
- the goodwill asset is sold; or
- the goodwill asset ceases to exist.

3.59 Paragraph 14 of the Taxation Ruling states that:

> Goodwill is not a series of CGT assets that inhere in other identifiable assets of a business. Goodwill, being a composite thing, attaches to the whole of the business. It does not attach separately to each identifiable asset of the business. Nor is there an element of goodwill in each identifiable asset of a business.

3.60 Consequently, the tax costs for assets that are treated as goodwill will not be recognised at the joining time or when, for example, a CGT event happens to the asset.

3.61 The Taxation Ruling also states that the goodwill of a business is a single CGT asset (paragraph 16). However, the Taxation Ruling also discusses the issue as to whether there is a disposal of goodwill on a disposal of one of several businesses or on the disposal of something less than a business (paragraphs 70 to 79).

> 'If a business owner is carrying on more than one business, each business has its own separate goodwill and each business may be disposed of along with the goodwill attaching to it.' (Paragraph 73 of Taxation Ruling TR 1999/16)

> 'If a business owner is carrying on one business and disposes of some part of that business, it is a question of fact as to whether the owner has disposed of a discrete business that a purchaser could conduct or has

merely disposed of a business asset or a collection of business assets. …If a business owner disposes of part of their business, an important consideration is whether the effect of the transaction is to put the purchaser in possession of a going concern the activities of which the purchaser could carry on without interruption.' (Paragraph 74 of Taxation Ruling TR 1999/16)

3.62 Under the pre-rules, an asset is treated as forming part of the goodwill asset if:

- the asset is an intangible asset, the value of which is attributable to the expected future profits from life insurance policies or general insurance policies;
- the asset is a customer relationship asset, know how or another accounting intangible asset that is not a CGT asset, a revenue asset, a depreciating asset, trading stock, a Division 230 financial arrangement, goodwill or an asset that is excluded from the tax cost setting rules because of subsection 705-30(2); or
- the asset is a non-deductible right to future income.

[Schedule 3, items 6 and 11, subsection 701-63(3) of the pre-rules and the definition of 'asset forming part of goodwill' in subsection 995-1(1)]

3.63 An asset that is an intangible asset, the value of which is attributable to the expected future profits from life insurance policies or general insurance policies for both existing and anticipated policy holders may or may not form part of legal goodwill. Paragraph 701-63(3)(a) ensures that an asset whose value is attributable to expected future profits from both existing and anticipated policies (however those expected future profits are classified for actuarial, accounting or other purposes) is treated as an asset forming part of the goodwill of a business of the joining entity.

3.64 The value of an insurance business may also reflect anticipated benefits from the future recoupment of past acquisition costs. Acquisition costs broadly represent expenses involved in obtaining new customers and establishing their policies. In some cases, the anticipated future revenues of a life insurance business seen as recouping acquisition costs exceed anticipated future outgoings, resulting in an overall debit balance liability for a policy or group of policies. Thus, these debit balances represent expected future profits from life insurance policies (even though those profits offsetting corresponding acquisition costs).
Paragraph 701-63(3)(a) also ensures that these expected future profits are treated as an asset forming part of the goodwill of a business of the joining entity.

3.65 Paragraph 701-63(3)(b) specifies that a customer relationship asset, know how or another accounting intangible asset that is not otherwise recognised for tax purposes is treated as an asset forming part of the goodwill of the business of the joining entity asset. Examples of other accounting intangible assets include:

- customer related intangible assets — such as customer lists, order or production backlogs, and customer relationships;
- marketing related intangible assets — such as unregistered trademarks and trade names; and
- technology based intangible assets — such as information databases and trade secrets (such as secret formulas, processes or recipes).

Part 2 — Interim rules

3.66 The interim rules amend the operation of the current law as modified by the pre-rules. These rules apply to, broadly, the period between 12 May 2010 and 30 March 2011. These amendments restore the current rights to future income and residual tax cost setting rules. However, modifications are made to:

- treat certain assets as goodwill;
- ensure that no value is attributed to certain contractual rights to future income; and
- ensure that the reset tax costs for consumable stores are deductible.

3.67 The objective of the interim rules is to protect taxpayers who acted on the basis of the 2010 law before the Board of Taxation Review was announced. The modifications address material uncertainties in the operation of the 2010 law, and ensure that the law operates as intended.

Current rights to future income and residual tax cost setting rules restored

3.68 The interim rules restore the current rights to future income and residual tax cost setting rules. That is, the rules restore the following provisions:

- subsections 701-55(5C) and (6);
- subsections 701-56(1) and (2);

- section 701-90 (noting that the definition of 'right to future income' in former subsection 701-90(1) has been relocated to subsection 701-63(5));
- paragraph 705-25(5)(d); and
- sections 716-405 and 716-410.

[Schedule 3, items 15 to 21, 23 and 24, subsections 701-55(5C) and (6), subsections 701-56(1) and (2), subsection 701-63(5), section 701-90, paragraph 705-25(5)(d) and sections 716-405 and 716-410 of the interim rules]

3.69 The operation of these rules is explained in detail in the explanatory memorandum, and the supplementary memorandum, to Tax Laws Amendment (2010 Measures No. 1) Bill 2010.

Certain assets treated as goodwill

3.70 The first modification to the current law that is made by the interim rules is to treat certain assets held by an entity that becomes a subsidiary member of a consolidated group as forming part of the goodwill asset of a business of the joining entity. The assets which are treated as part of the goodwill of a business may include:

- some assets which are already legal goodwill under general principles; and
- some assets which are not legal goodwill.

3.71 That is, under the interim rules, for the purposes of applying the consolidation provisions in Part 3-90 to an entity that becomes a subsidiary member of a consolidated group:

- the goodwill of a business of the joining entity is treated as a single asset;
- an asset of that business that is an asset forming part of goodwill is treated as being part of that single asset; and
- as a result, an asset forming part of goodwill is not treated as a separate asset.

[Schedule 3, item 19, subsections 701-63(1) and (2) of the interim rules]

3.72 If the joining entity has not allocated allocable cost amount to a goodwill asset, the tax cost setting amounts for the assets treated as forming part of goodwill will effectively be the tax cost setting amount for the goodwill asset of each relevant business of the joining entity.

3.73 The current taxation treatment of assets that are goodwill is broadly outlined in paragraphs 3.58 to 3.61.

3.74 Under the interim rules, an asset is treated as forming part of the goodwill asset if:

- the asset is a customer relationship asset, know how or another accounting intangible asset that is not a CGT asset, a revenue asset, a depreciating asset, trading stock, a Division 230 financial arrangement, goodwill or an asset that is excluded from the tax cost setting rules because of subsection 705-30(2); or

- the asset is a non-deductible right to future income.

[Schedule 3, items 11 and 19, subsection 701-63(3) of the interim rules and the definition of 'asset forming part of goodwill' in subsection 995-1(1)]

3.75 Under the interim rules, an asset is a ***non-deductible right to future income*** if it is a right to future income that arises under a contract or agreement entered into by the joining entity with another entity (the customer) to the extent that the value of the right:

- is contingent on the renewal of the contract or agreement;

- is attributable to the period, if any, during which the customer can unilaterally cancel the contract or agreement without paying compensation or a penalty; or

- if there is a period during which the customer can unilaterally cancel the contract or agreement but must pay compensation or a penalty, is attributable to that period but not to that compensation or penalty.

[Schedule 3, items 12 and 19, subsection 701-63(4) of the interim rules and the definition of 'non-deductible right to future income' in subsection 995-1(1)]

3.76 A right to future income under a contract or agreement entered into by a joining entity with another entity (the customer) that is contingent on an expectation that the customer will renew the contract or agreement is uncertain. In this regard, the right is not an existing right to future income but is a mere expectation that cannot be attributed to those existing rights. Therefore, the right is a non-deductible right to future income that is treated as goodwill.

3.77 A right to future income under a contract or agreement entered into by a joining entity with the customer is uncertain if the customer can unilaterally cancel the contract or agreement at any time without paying

compensation or a penalty. In this regard, the right is not an existing right to future income but is a mere expectation that cannot be attributed to those existing rights. Therefore, the right is a non-deductible right to future income that is treated as goodwill.

3.78 If the customer can unilaterally cancel the contract or agreement at any time but must pay compensation or a penalty, the value of the contract or agreement that is attributable to the compensation or a penalty, is not a non-deductible right to future income.

3.79 Ultimately it will be a question of fact as to whether a customer can unilaterally cancel a contract or agreement. If customer can cancel the contract or agreement only in circumstances that are beyond the customer's control, then the contract or agreement would not be a non-deductible right to future income. This could include, for example:

- a contract or agreement that can be cancelled by the customer only if there is a material breach of the terms of the contract by the consolidated group after the joining time; or
- a contract or agreement that can be cancelled by the customer only if the consolidated group is unable to fulfil its obligations under the contract or agreement due to forces (either natural or human) beyond its control — that is, the contract or agreement contains a force majeure clause.

3.80 Similarly, if a customer can unilaterally cancel a contract or agreement but only by paying compensation or a penalty that is punitive, it is likely that the contract or agreement would not be a non-deductible right to future income.

3.81 The question as to whether an entity can unilaterally cancel a contract or arrangement without paying compensation or a penalty can only be determined as a question of fact having regard to the circumstances of a particular case. However, the following examples illustrate the outcomes that could arise in some situations.

Example 3.1

Company A joins Head Co's consolidated group. Company A has entered into a contract with a customer to transport minerals from a mine site to a port. The customer is able to cancel the contract if Company A is unable to fulfil its obligations to transport minerals under the contract for a period of 12 months due to circumstances beyond Company A's control, such as a natural disaster which damages the infrastructure used to transport the minerals — that is, the contract or agreement contains a *force majeure* clause.

Company A's right to future income will not be a non-deductible right to future income because the customer is unable to unilaterally cancel the contract. That is, the customer can only cancel the contract in extraordinary and unexpected circumstances that are beyond its control.

Example 3.2

Company A joins Head Co's consolidated group. Company A has entered into an on-going funds management contract with a customer. The customer is unable to cancel the contract within the first two years. Once those two years have expired, the customer is able to cancel the contract at any time, but must give three months advance notice of its intention to cancel the contract.

Company A's right to future income is effectively non-cancellable for the first two years and three months of the contract. Therefore, to the extent that the value of the right to future income exceeds the value attributable to the non-cancellable period, the right will be a non-deductible right to future income that is treated as forming part of goodwill.

Example 3.3

Company A joins Head Co's consolidated group. Company A has entered into a contract to provide services to a customer. The customer is unable to cancel the contract within the first two years. Once those two years have expired, the customer is able to cancel the contract at any time, but must pay a fee to Company A on the termination of the contract.

Company A's right to future income is non-cancellable for the first two years of the contract. Therefore, to the extent that the value of the right to future income exceeds the value attributable to the non-cancellable period and the value of the fee payable on termination, the right will be a non-deductible right to future income that is treated as forming part of goodwill.

Example 3.4

Company A joins Head Co's consolidated group. Company A has entered into a telecommunications contract with a customer. The contract expires after two years. Once those two years have expired, Company A continues to provide telecommunications services to the customer until they choose to cancel the contract.

Company A's right to future income is non-cancellable for the first two years of the contract. Therefore, to the extent that the value of the right to future income exceeds the value attributable to the non-cancellable period, the right will be a non-deductible right to future income that is treated as forming part of goodwill.

No value is attributed to certain contractual rights to future income

3.82 A second modification to the current law that is made under the interim rules is to ensure that no value is attributed to certain rights to future income.

3.83 The modification applies where

- the joining entity holds an asset;
- under the terms of a contract or agreement, the joining entity holds a right to future income arising from the asset; and
- the right to future income is not a non-deductible right to future income in relation to the joining entity.

[Schedule 3, item 22, subsection 705-56A(1)]

3.84 In these circumstances, the amount of the reset tax cost for the right to future income will depend on whether or not the market value of the asset at the joining time (disregarding the right to future income) exceeds the sum of:

- the market value of the asset at the joining time (having regard to the right to future income); and
- the market value of the right to future income at that time.

[Schedule 3, item 22, subsection 705-56A(2)]

3.85 If the sum of those amounts does exceed the market value of the asset at the joining time (disregarding the right to future income), then the market value of the right to future income is taken to be the amount of the excess for the purposes of working out the reset tax cost for the right to future income under section 705-35. ***[Schedule 3, item 22, subsection 705-56A(3)]***

3.86 If the sum of those amounts does not exceed the market value of the asset at the joining time (disregarding any encumbrances on the asset), then:

- the right to future income is not taken into account under the tax cost setting rules; and
- the right to future income's tax cost setting amount is taken to be nil.

[Schedule 3, item 22, subsection 705-56A(4)]

Consumable stores are deductible

3.87 A third modification to the current law that is made under the interim rules is to retain the specific provision (inserted in the pre-rules) which ensures that the head company can apply the general deduction provision to deduct the reset tax costs for consumable stores is retained under the interim rules. ***[Schedule 3, item 1, subsection 701-55(5D)]***

Part 3 — Prospective rules

3.88 The prospective rules amend the operation of the current law as modified by both the pre-rules and the interim rules. These rules apply to, broadly, the period after 30 March 2011. These amendments:

- restrict the operation of the tax cost setting rules to CGT assets, revenue assets, depreciating assets, trading stock and Division 230 financial arrangements;
- apply a business acquisition approach to the residual tax cost setting rule;
- ensure that the reset tax costs for rights to future income that are WIP amount assets and consumable stores are deductible; and
- treat rights to future income, other than WIP amount assets, as retained cost base assets.

3.89 The objective of the prospective rules is to increase certainty for taxpayers by making the tax outcomes for consolidated groups more consistent with the tax outcomes that arise when assets are acquired by entities outside the consolidation regime. In this regard:

- by restricting the tax cost setting rules to CGT assets, revenue assets, depreciating assets, trading stock and Division 230 financial arrangements, those rules will not result in tax costs being allocated to assets that are not ordinarily recognised for taxation purposes — this will improve the integrity of the consolidation regime as consolidated groups will not seek to find ways to deduct the tax cost allocated to such assets;
- by applying a business acquisition approach to the residual tax cost setting rule, assets acquired by a consolidated group as a result of acquiring an entity will generally be taken to be on capital account — this will ensure that the tax costs

allocated to assets will be recognised only when a CGT event happens to the asset rather than giving rise to immediate revenue deductions;

- by ensuring that the reset tax costs for rights to future income that are WIP amount assets and consumable stores are deductible, consolidated groups will have certainty that revenue deductions can be claimed for these assets; and
- by treating rights to future income (other than WIP amount assets) as retained cost base assets, the consolidation tax cost setting rules will not result in substantial uplifts in the amount of the tax costs for these assets.

Restrict the tax cost setting rules to assets that are recognised for taxation purposes

3.90 Under the prospective rules, the consolidation provisions will apply to an asset only if the asset is one or more of the following:

- a CGT asset;
- a revenue asset;
- a depreciating asset;
- trading stock; or
- a thing that is, or is part of, a Division 230 financial arrangement.

[Schedule 3, item 34, section 701-67]

3.91 In this regard, a CGT asset is defined in section 108-5 to mean:

- any kind of property; or
- a legal or equitable right that is not property.

3.92 Therefore, most revenue assets, depreciating assets, trading stock and Division 230 financial arrangements are CGT assets. However, mining, quarrying and prospecting information is an example of a depreciating asset that is not a CGT asset (see Taxation Ruling TR 98/3).

3.93 As a result, the tax cost setting rules will not result in tax costs being allocated to assets that are not ordinarily recognised for taxation purposes. This will improve the integrity of the consolidation regime as

consolidated groups will not seek to find ways to deduct the tax cost allocated to such assets.

3.94 Examples of assets that may not be CGT assets, revenue assets, depreciating assets, trading stock or Division 230 financial arrangements include:

- customer related intangible assets — such as customer lists, order or production backlogs, and customer relationships;
- marketing related intangible assets — such as unregistered trademarks and trade names; and
- technology based intangible assets — such as information databases and trade secrets (such as secret formulas, processes or recipes).

3.95 As the business capital expenditure provision (section 40-880) cannot apply to expenditure for CGT assets, revenue assets, depreciating assets, trading stock or Division 230 financial arrangements, a consequential amendment is made to remove the reference to the business capital expenditure provision in the list of provisions excluded from the scope of the residual tax cost setting rule. ***[Schedule 3, item 32, paragraph 701-56(3)(d)]***

3.96 Under the current law, certain assets (excluded assets) are not allocated a tax cost setting amount. Excluded assets are not CGT assets, revenue assets, depreciating assets, trading stock or Division 230 financial arrangements. Therefore, consequential amendments are made to remove references to excluded assets from the tax cost setting provisions. ***[Schedule 3, items 27 and 37 to 41, sections 705-35 and 705-40]***

Apply a business acquisition approach to the residual tax cost setting rule

3.97 Under the prospective rules, the residual tax cost setting rule in the current law (inserted by the interim rules) will be retained. ***[Schedule 3, item 16, subsection 701-55(6)]***

3.98 However, for the purpose of applying the residual tax cost setting rule to the assets of an entity that joins a consolidated group, the head company will be taken to have acquired all of the assets of the joining entity as part of acquiring the business of the joining entity as a going concern. ***[Schedule 3, items 29 to 31, subsections 701-56(1), (1A), (1B) and (2) of the prospective rules]***

3.99 As a result of applying a business acquisition approach to the residual tax cost setting rule, the head company will be treated as having

acquired the assets of the joining entity as if they were acquired directly, as part of a business acquisition. The revenue or capital character of the assets will then be determined based on the character of the assets in the hands of the head company, rather than the joining entity.

3.100 A business is a going concern if it has not been stopped — that is, essentially any business which is not being wound up is a going concern. Therefore, a business which is a going concern has goodwill as a legal asset. By deeming the actual acquisition by the head company of the joining entity's membership interests to be the acquisition of the joining entity's assets as part of the acquisition of a business that is a going concern, and therefore a business that has goodwill, the acquisition of the assets by the head company is likely to be on capital account.

3.101 However, there may be some limited circumstances where the application of the business acquisition approach to a particular asset results in the asset being on revenue account. In that event, the residual tax cost setting rule (subsection 701-55(6)) will apply to allow the reset tax cost for the asset to be recognised.

WIP amount assets are deductible

3.102 Under the prospective rules, section 25-95 will apply to determine the whether the reset tax cost for rights to future income that are WIP amount assets is deductible.

3.103 In this regard, section 25-95 specifies the circumstances in which taxpayers can deduct work in progress amounts. Therefore, where an entity that joins a consolidated group holds a WIP amount asset, section 25-95 will apply as if the head company had paid a work in progress amount for the income year in which the joining time occurs equal to the reset tax cost for the asset. ***[Schedule 3, item 28, subsection 701-55(5C) of the prospective rules]***

3.104 A ***WIP amount asset*** is an asset that is in respect of work (but not goods) that has been partially performed by a recipient mentioned in paragraph 25-95(3)(b) for a third party but not yet completed to a stage where a recoverable debt has arisen in respect of the completion of the work. ***[Schedule 3, items 33 and 48, subsection 701-63(6) of the prospective rules and the definition of 'WIP amount asset' in subsection 995-1(1)]***

3.105 The objective of restricting this deduction to the reset tax cost for rights to future income that are WIP amount assets is to ensure that consolidated groups do not get a deduction that is not available to entities that cannot, or choose not to, consolidate.

Consumable stores deductible

3.106 The modification inserted by the pre-rules to ensure that the head company can apply the general deduction provision to deduct the reset tax costs for consumable stores is retained under the prospective rules. ***[Schedule 3, item 1, subsection 701-55(5D)]***

Rights to future income, other than WIP amount assets, are retained cost base assets

3.107 Under the prospective rules, a right to future income (other than a WIP amount asset) will be a retained cost base asset, with a tax cost setting amount equal to the joining entity's terminating value for the asset. ***[Schedule 3, item 36, paragraph 705-25(5)(d) of the prospective rules]***

3.108 Under these rules, a ***right to future income*** is a valuable right (including a contingent right) to receive an amount if:

- the valuable right forms part of a contract or agreement;
- the market value of the valuable right (taking into account all the obligations and conditions relating to the right) is greater than nil;
- the valuable right is neither a Division 230 financial arrangement nor part of a Division 230 financial arrangement; and
- it is reasonable to expect that an amount attributable to the right will be included in the assessable income of any entity at a later time.

[Schedule 3, item 13 and 33, subsection 701-63(5) of the prospective rules and the definition of 'right to future income' in subsection 995-1(1)]

3.109 The definition of rights to future income under the prospective rules is broader than the definition in the pre-rules and the interim rules. That is, under the prospective rules, rights to future income are not restricted to rights to receive an amount for the performance of work or services or the provisions of goods. This will ensure that other contractual rights to future income (such as a right to income that arises under an insurance contract or a reinsurance contract) are treated as retained cost base assets.

Removal of interim rules

3.110 Under the prospective rules, specific provisions that applied under the interim rules will be removed. These are:

- the rules to allow a deduction for rights to future income under the interim rules — that is, subsections 701-56(1) and (2) and sections 701-90, 716-405 and 716- 410; and

- the rules to ensure that no value is attributed to certain rights to future income — that is, section 705-56A.

[Schedule 3, items 30, 31, 35, 42, and 43 to 47]

Application and transitional provisions

3.111 The changes affecting a corporate acquisition will depend on the time when the acquisition took place. That is, different changes apply, with certain exceptions, to:

- acquisitions that took place before 12 May 2010 — in this case the pre-rules apply;

- acquisitions that took place between 12 May 2010 and 30 March 2011 — in this case the interim rules apply; and

- acquisitions that took place on or after 31 March 2011— in this case the prospective rules apply.

3.112 The changes are necessary to protect a significant amount of revenue that would otherwise be at risk, and to make the tax outcomes for consolidated groups more consistent with those for entities outside consolidation.

3.113 As the 2010 amendments operated with effect back to 2002, some of the further changes need to do so too. These changes (the pre-rules) prevent the retrospective operation of unintended effects of, and perceived weaknesses in, the law.

3.114 The interim rules protect taxpayers who acted on the basis of the current law before the Board of Taxation review of the operation of the residual tax cost setting and rights to future income rules was announced.

3.115 The prospective rules primarily implement the recommendations made by the Board of Taxation to improve the operation of the consolidation tax cost setting rules. These changes will increase certainty for taxpayers and make the tax outcomes for consolidated groups more consistent with the tax outcomes that arise when assets are acquired by entities outside the consolidation regime.

Application of the pre-rules

3.116 The pre-rules apply to the head company of a consolidated group or multiple entry consolidated group for an income year in respect of an entity that becomes a member of the group if:

- the joining time was before 12 May 2010; or
- the arrangement under which the joining entity joined the group commenced before 10 February 2010.

[Schedule 3, item 49 and subitems 50(1) and (2)]

3.117 However, the pre-rules will not apply in respect of an income year if:

- the interim rules apply for that income year;
- the arrangement or transaction is covered by a notice of assessment for that income year which issued before 12 May 2010 that comes within the scope of subitem 50(5); or
- the special rule in item 51 for an arrangement or transaction covered by a private ruling or written advice given by the Commissioner of Taxation (Commissioner) under an Annual Compliance Arrangement applies.

[Schedule 3, item 49, subitem 50(3), subitem 50(5) and item 51]

3.118 If an arrangement or transaction is covered by a notice of assessment for an income year which was served on the head company by the Commissioner before 12 May 2010, the original 2002 law will apply to the arrangement or transaction unless:

- the head company requests an amendment to the assessment and the amendment relates to the application of subsection 701-55(6) of the original 2002 law in respect of the joining entity; or
- the amendment of the assessment relates to an asset that is a customer relationship asset, know-how or another accounting intangible asset and would be inconsistent with the treatment of those assets under the pre-rules.

[Schedule 3, item 49 and subitems 50(5) and (6)]

3.119 Therefore, where an assessment for an income year issued before 12 May 2010 based on the law that applied at that time (that is, the original 2002 law), the assessment will generally be unaffected by the changes made to the original 2002 law by the pre-rules.

3.120 If the head company has claimed a deduction in an income year for an unbilled income asset or consumable stores, the pre-rules will apply and the deduction will be allowed. Similarly, if a head company that is covered by the pre-rules makes a request for an amendment to a prior year income tax return to claim a deduction for an unbilled income asset or consumable stores, the pre-rules (rather than the original 2002 law) will apply so that the deduction will be allowed.

3.121 In addition, if a deduction for an asset that is a customer relationship asset, know-how or another accounting intangible asset was allowed under an assessment issued to the head company for an income year, the Commissioner can amend the assessment and apply the pre-rules to treat the asset as goodwill.

Application of the interim rules

3.122 The interim rules apply to the head company of a consolidated group or multiple entry consolidated group for an income year in respect of an entity that becomes a member of the group if:

- the pre-rules would otherwise apply (because the joining time was before 12 May 2010 or the arrangement under which the joining entity joined the group commenced before 10 February 2010) but the head company's latest notice of assessment for the income year that relates to the application of the 2010 law in respect of the joining entity was served on the head company by the Commissioner between 12 May 2010 and 30 March 2011; or

- the joining time was on or after 12 May 2010 and the arrangement under which the joining entity joined the group commenced between 10 February 2010 and 30 March 2011.

[Schedule 3, item 49, subitems 50(1) and (3), and item 52]

3.123 Therefore, if the joining time was before 12 May 2010 or the arrangement under which the joining entity joined the group commenced before 10 February 2010 (so that the pre-rules generally apply) and the joining entity holds, for example, a right to future income that is not unbilled income, then:

- if the Commissioner has served a notice of assessment or amended assessment for an income year on the head company between 12 May 2010 and 30 March 2011 allowing a deduction for the claim, the interim rules will apply for that income year so that the deduction is allowed; and
- the pre-rules will apply to the tail of claims for deduction in subsequent income years (and therefore a deduction may not be allowed in those subsequent income years).

3.124 However, if the joining time was on or after 12 May 2010 and the arrangement under which the joining entity joined the group commenced between 10 February 2010 and 30 March 2011, the interim rules will apply to allow a deduction for the tail of claims in all income years.

Application of the prospective rules

3.125 The prospective rules apply to the head company of a consolidated group or multiple entry consolidated group for an income year in respect of an entity that becomes a member of the group if:

- the joining time is on or after 31 March 2011; and
- neither the pre-rules nor the interim rules apply to the arrangement.

[Schedule 3, item 49 and subitems 50(1) and (4)]

Special rule for private rulings

3.126 The amendments will not apply where a claim is covered by:

- a private binding ruling issued before 31 March 2011; or
- written advice given by the Commissioner before 31 March 2011 under an Annual Compliance Arrangement.

[Schedule 3, subitems 51(1) and (2)]

3.127 In these circumstances, if the ruling or written advice was issued under the original 2010 law, that law will apply to the transaction

3.128 However, if the head company requests an amendment in relation to a matter covered by a ruling or written advice after it has been issued, item 51 does not apply to the extent that the request is inconsistent with or contrary to the ruling or advice. ***[Schedule 3, subitem 51(3)]***

Commencement of an arrangement

3.129 The time that an arrangement is taken to commence is outlined in Table 3.1. ***[Schedule 3, item 52]***

Table 3.1: Commencement of an arrangement

Type of arrangement	***Time that the arrangement commences***
Off-market takeover bid	The day on which the bidder lodged with the Australian Securities and Investments Commission a notice stating that the bidder's statement and offer document have been sent to the target (that is, step 4 in the table in subsection 633(1) of the *Corporations Act 2001* (Corporations Act) is completed.
On-market takeover bid	The day on which the bidder announced the bid to the relevant financial market (that is, step 2 in the table in subsection 635(1) of the Corporations Act is completed).
Scheme of arrangement	The day on which a company applies for a court order, under subsection 411(1) of the Corporations Act, for a meeting of the company's members, or one or more classes of the company's members, about the arrangement.
Other arrangement	The day on which the decision to enter into the arrangement (including an initial public offering) was made.

No interest payable on income tax refunds or where additional tax becomes payable

3.130 Attachment A of the then Assistant Treasurer's Media Release No. 159 of 25 November 2011 specified that the amendments will ensure that no interest is payable on income tax refunds for the period prior to 12 May 2010 as a result of an amendment to allow a deduction because of the changes to the original 2002 rules. However, the amendments will not apply where the interest has already been paid to taxpayers.

3.131 In addition, no interest or penalties will be payable where additional tax becomes payable because the Commissioner amends an assessment that issued before 31 March 2011, or further amends an amended assessment that issued before that date, to disallow a deduction for a claim under the pre-rules or the interim rules.

3.132 The amendments to implement these changes are still being developed and will be introduced in a later bill.

Amendment of assessments

3.133 Generally, the Commissioner can amend an assessment of a company, other than a small business entity, within four years from the

date of the notice of assessment (section 170 of the *Income Tax Assessment Act 1936*).

3.134 As the pre-rules and the interim rules apply to periods in respect of which the four year amendment period has wholly or partly expired, the period for amending assessments will be extended. That is, the operation of section 170 will be modified so that it does not prevent the amendment of an assessment if:

- the assessment was made before the date of commencement of the amendments (that is the day on which the amendments receive Royal Assent);
- the amendment is made within two years after that date; and
- the amendment is made for the purpose of giving effect to the amendments in Schedule 3.

[Section 4]

Consequential amendments

3.135 Consequential amendments are made to:

- modify the list of provisions about deductions under the prospective rules;
- correct cross references in section 701-58; and
- remove redundant definitions.

[Schedule 3, items 5, 25, 26, 45, 46 and 47, sections 12-5 and 701-58]

STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Consolidation

3.136 This Schedule is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview

3.137 This Schedule amends the ITAA 1997 to modify the consolidation tax cost setting and rights to future income rules so that the tax outcomes for consolidated groups are more consistent with the tax outcomes that arise when assets are acquired outside the consolidation regime.

Human rights implications

3.138 This Schedule does not engage any of the applicable rights or freedoms.

Conclusion

3.139 This Schedule is compatible with human rights as it does not raise any human rights issues.

Assistant Treasurer, the Hon David Bradbury

Chapter 4
Change to managed investment trust final withholding tax rate

Outline of chapter

4.1 The Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2012 amends the *Income Tax (Managed Investment Trust Withholding Tax) Act 2008* to increase the managed investment trust (MIT) final withholding tax from 7.5 per cent to 15 per cent on fund payments made in relation to income years that commence on or after 1 July 2012.

4.2 Schedule 4 to Tax Laws Amendment (2012 Measures No. 2) Bill 2012 makes consequential amendments to the *Taxation Administration Act 1953* to give effect to the increase in the MIT final withholding tax rate imposed by the Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2012.

Context of amendments

4.3 This amendment will increase the MIT final withholding tax from 7.5 per cent to 15 per cent on fund payments made in relation to income years that commence on or after 1 July 2012.

Summary of new law

4.4 The amendment will increase the MIT final withholding tax rate from 7.5 per cent to 15 per cent. The MIT final withholding tax rate of 15 per cent will apply to fund payments made in relation to income years that commence on or after 1 July 2012.

Comparison of key features of new law and current law

New law	*Current law*
The MIT final withholding tax rate of 15 per cent applies to fund payments made in relation to income years that commence on or after 1 July 2012.	The tax rate of MIT final withholding is 7.5 per cent.

Detailed explanation of new law

4.5 The rate of MIT final withholding tax is prescribed in subparagraph 4(1)(a)(ii) of the *Income Tax (Managed Investment Trust Withholding Tax) Act 2008*.

4.6 The Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2012 will amend subparagraph 4(1)(a)(ii) to increase the MIT final withholding tax rate from 7.5 per cent to 15 per cent on fund payments made in relation to income years that commence on or after 1 July 2012. ***[Schedule 4 to the Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2012, item 1, subparagraph 4(1)(a)(ii)]***

Application and transitional provisions

4.7 The 15 per cent tax rate will apply to fund payments made in relation to income years that commence on or after 1 July 2012. ***[Schedule 4 to the Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2012, item 1, subparagraph 4(1)(a)(ii)]***

Consequential amendments

4.8 The MIT final withholding tax rate is also prescribed in subsections 12-390(3) and 12-390(6) of Schedule 1 to the *Taxation Administration Act 1953*.

4.9 Schedule 4 of Tax Laws Amendment (2012 Measures No. 2) Bill 2012 makes consequential amendments to subsections 12-390(3) and 12-390(6) of Schedule 1 to the *Taxation Administration Act 1953* to reflect the new 15 per cent final MIT withholding tax rate. ***[Schedule 4 to Tax Laws Amendment (2012 Measures No. 2) Bill 2012, items 1 to 3, subparagraphs 12-385(3)(a)(iii), 12-390(3)(a)(iii) and 12-390(6)(a)(iii)]***

STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Change to managed investment trust final withholding tax rate

4.10 The Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2012 and Schedule 4 of the Tax Laws Amendment (2012 Measures No. 2) Bill 2012 is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview

4.11 The purpose of the amendment is to raise the MIT final withholding tax rate from 7.5 per cent to 15 per cent.

Human rights implications

4.12 This amendment does not engage any of the applicable rights or freedoms.

Conclusion

4.13 This amendment is compatible with human rights as it does not raise any human rights issues.

Assistant Treasurer, the Hon David Bradbury

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